

# Diversinet

## 2007 Annual Report



To Our Shareholders:

Fiscal 2007 was a year of transition for Diversinet, moving from a product development focused company towards a sales and marketing enterprise. This was highlighted by the introduction of our flagship MobiSecure Wallet and Vault product suite in early 2007, the licensing of our products by strategic partners, a 172% year over year increase in our revenue, and the continued expansion of our distribution channels.

Our significant 2007 business and product achievements included:

- A license and revenue share agreement to provide our MobiSecure™ Wallet and Vault mobile secure access solution to AllOne Health Group and to cross license certain software and share revenues from the sales of the combined software. Under the three year agreement, Diversinet will receive \$2 million annually as a minimum commitment from AllOne. Diversinet and AllOne will initially focus on potential sales from the Blue Cross Blue Shield Association licensees and other customers looking to mobilize personal health records in the United States.
- A three year license and VAR agreement to provide our MobiSecure™ Wallet and Vault mobile secure access solution to Intersections Inc., a leading provider of identity theft protection and credit management solutions for consumers. With over 5 million customers, this relationship will allow Intersections to offer users secure and immediate access to a host of personal, financial, and insurance identity information, as well as other critical, privileged data. Diversinet's MobiSecure Wallet and Vault will provide Intersections with a mobile and desktop security platform it can use to extend its core offering to broad user base.
- In August 2007 we completed a private placement of 6,756,757 common shares at \$0.74 per common share, for gross proceeds of \$5,000,000 to Hospital Service Association of Northeastern Pennsylvania, d/b/a Blue Cross of Northeastern Pennsylvania ("BCNEPA"). William Reed, executive vice president of BCNEPA has joined the Diversinet Board of Directors.
- The appointment of Albert Wahbe as CEO of Diversinet brings seasoned leadership to Diversinet after a distinguished career as a senior executive at both Scotiabank and IBM. Diversinet also appointed Philippe Tardif and Greg Milavsky to the Board of Directors. Mr. Tardif, a partner at Borden Ladner Gervais LLP and a leading securities and capital markets lawyer, brings to Diversinet considerable experience in corporate governance matters, and has a unique perspective on the needs of helping companies transition towards sales and marketing enterprises. Mr. Milavsky joins the Diversinet board in his role as senior managing director and founder of Canterbury Park Capital L.P., a private equity firm based in Toronto, Canada. Prior to this position, he served as managing director and group head for Scotiabank Private Equity Investments, a firm specializing in private equity and venture investing.
- The awarding of two new patents, now totalling 9 patents, with 19 more still pending, which improves Diversinet's ability to monetize its intellectual property through licensing opportunities.
- The release of Diversinet's next-generation MobiSecure™ Wallet and Vault a Mobile value added secure platform that extends enterprises core applications and services to the mobile channel.

As we head into 2008, we are excited by the many new opportunities being created by the rapid introduction of a broad range of powerful mobile devices and the adoption of products including the MobiSecure™ payment product line. We will continue to seek new distribution partnerships, forge alliances with technology leaders and develop exciting new products and services to meet the growing needs of consumers and businesses for security in a mobile world.

I would like to again thank our shareholders, our dedicated staff and our business partners for their support over this past year. I look forward to working together with you all to build upon on the significant gains we accomplished during 2007.

Regards,



Albert Wahbe  
Chairman and Chief Executive Officer

## Management's Discussion and Analysis of Financial Condition and Results of Operations

The following Management's Discussion and Analysis ("MD&A"), is intended to help the reader understand the results of operations and financial condition of Diversinet Corp. ("Diversinet" or the "Company"). The MD&A should be read in combination with our audited consolidated financial statements and the accompanying notes. We report our audited consolidated financial statements in accordance with Canadian generally accepted principles ("GAAP"). All dollar amounts in this MD&A are in United States, or U.S. dollars or unless otherwise stated.

Certain statements in this MD&A contain words such as "could", "expects", "may", "anticipates", "believes", "intends", "estimates", "plans", and other similar language and are considered forward-looking statements or information under applicable securities laws. These statements are based on our current expectations, estimates, forecasts and projections about the operating environment, economies and markets in which we operate which we believe are reasonable but which are subject to important assumptions, risks and uncertainties and may prove to be inaccurate. Consequently, our actual results could differ materially from our expectations set out in this MD&A. In particular, see the Risk and Uncertainties section of this report and our Annual Report for the year ended December 31, 2007 (2007 Annual Report) for factors that could cause actual results or events to differ materially from those contemplated in forward-looking statements. Unless required by applicable securities laws, we disclaim any intention or obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. You are cautioned not to place undue reliance on these statements, which speak only as of the date of this report which is as at February 22, 2008.

Please find enclosed the Consolidated Balance Sheets as at December 31, 2007 and 2006, the Consolidated Statements of Earnings and Deficit and the Consolidated Statements of Cash Flows for the years ending December 31, 2007, 2006, and 2005, and the Notes to Consolidated Financial Statements for Diversinet Corp. Our financial statements have been prepared in accordance with Canadian generally accepted accounting principals (GAAP). These principles conform in all material respect with U.S. GAAP except as described in Note 14 to our consolidated statements. All financial figures are in U.S. dollars unless otherwise noted. The following discussion should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere in this annual report.

The differences between line items under Canadian GAAP and those under U.S. GAAP are not significant except that, under U.S. GAAP, our total loss would be less by \$439,000 for the year ending December 31, 2005. These differences relate to differences in accounting for stock-based compensation.

### Overview: Our Business and Strategy

Founded in 1997 and based in Toronto, Canada, Diversinet is a provider of personal authentication and security solutions for the wireless world. Our software and solutions protect user identity and provide secure access for consumer and business applications using a variety of mobile phones, Personal Digital Assistants ("PDA") and personal computers. Our scalable, open mobile security platform enables enterprises and service providers to rapidly develop, deploy and manage next-generation wireless security services. Our technology simplifies what had previously been a complex set of technical problems in both information security and wireless data communications. In January 2005, Diversinet began to focus on the evolving protection and trust needs of mobile users. These financial results reflect this shift in focus and the time required to build up a customer base under this new strategy and a rebuilding of the sales and marketing strategy of the Company.

Diversinet's MobiSecure soft tokens and MobiSecure Authentication Service Center ("MASC") enable health care service providers, identity management service providers, financial service providers, mobile network operators and security service providers to rapidly develop, deploy and manage secure on-line services for mobile device and personal computer users worldwide. Our MobiSecure soft tokens are securely provisioned and managed by MASC and are available on the leading intelligent mobile device platforms, including Symbian, Microsoft, RIM, Palm and Java-based phones as well as on personal computers running Microsoft Windows.

Diversinet's MobiSecure Wallet is a client-side secure container application, which can access or hold confidential personal information, such as user identification and access information via fax, email and SMS. It operates in concert with the MobiSecure Vault, a server-side secure container application, and allows a user to access a host of personal information files. Personal health records, financial information, payment information, entertainment or loyalty information can be accessed in real time, directly from a user's mobile phone or other hand-held access device. The MobiSecure Vault provides large file storage and backup to the MobiSecure Wallet and is accessible through web service interfaces and adaptors.

Diversinet's combination of client software and wireless provisioning services enables the issuance and management of mobile device authentication tokens and also creates a technology platform from which we can provide an entirely new and powerful set of capabilities in the mobile e-commerce environment in the form of digital identities, digital permissions and wireless wallets. In addition to providing mobile device security and provisioning solutions, Diversinet deploys an experienced professional services team for application development, consulting, training and technical support.

We signed a License and Revenue Share Agreement with AllOne Health Group, Inc., ("AllOne") a wholly owned subsidiary of BCNEPA, to cross license certain software and share revenues from the sales of the combined software. Under the three year agreement, Diversinet will receive \$2 million annually as a minimum commitment from AllOne. The agreement also contains commercial terms including software escrow, indemnification, support, and termination on change of control or material breach of the agreement. We will be initially focusing on potential sales from the Blue Cross Blue Shield Association licensees exclusively with AllOne and other customers in the mobile personal health record market in the United States.

During the second quarter of 2007, Albert Wahbe, the Company's Chairman, was appointed Chief Executive Officer pursuant to a one year consulting agreement renewable for a further one year period at the discretion of the Board. Mr. Wahbe's annual compensation consists of the issuance of up to 500,000 common shares, 200,000 of which are subject to the achievement of certain target conditions to be established by the Board. Mr. Wahbe brings seasoned leadership to Diversinet after a distinguished career as a senior executive at both Scotiabank and IBM.

In May 2007 we entered into a three year license and value added reseller ("VAR") agreement with Intersections Inc. ("Intersections") for our MobiSecure Wallet and MobiSecure Vault mobile secure access solutions. Intersections is a leading provider of identity theft protection and credit management solutions for consumers. MobiSecure Wallet and MobiSecure Vault will provide Intersections with a mobile security platform to offer its users secure and immediate access to a host of personal, financial, and insurance identity information, as well as other critical privileged data, thereby extending its current core offering and creating a host of new services that build closer, more personal and 'sticky' relationships with their more than five million users.

Under the Intersections arrangement, the Company has received cash payments totalling \$839,000, which includes \$675,000 relating to the license and VAR agreement for the first year and \$164,000 for various statements of work. Intersections intends to use the MobiSecure Wallet and MobiSecure Vault solution and re-brand it for a variety of new service and product offerings. These will be available directly through Intersections' Identity Guard® brand and through selected partners, opening up significant new distribution channels for Diversinet. This agreement provides for additional license fees in years two and three of the agreement based on user deployment. The agreement is cancellable by Intersections with 180 days notice.

In August 2007 we completed a private placement of 6,756,757 Diversinet common shares at \$0.74 per share, for gross proceeds of \$5,000,000 to Hospital Service Association of Northeastern Pennsylvania, d/b/a Blue Cross of Northeastern Pennsylvania ("BCNEPA"). William Reed, executive vice president of BCNEPA has joined the Diversinet board of directors. As at December 31, 2007, BCNEPA owns 6,856,757 common shares, representing approximately 15.9% of the issued and outstanding common shares of the Company.

On June 30, 2006, we completed a private placement of 6,680,001 units, at \$0.60 per unit, for gross proceeds of \$4,008,000. Each unit is comprised of one common share and one common share purchase warrant. One half of the warrant will be exercisable to purchase one common share for each whole warrant at a price of \$0.75, the other half warrant at \$0.90, and will expire on June 30, 2008. This transaction was effected as a private placement in accordance with Rule 506 of Regulation D promulgated under the Securities Act of 1933, as amended. We will use the net proceeds for working capital and general corporate purposes.

On July 26, 2006, we completed a private placement of 1,538,463 units, at \$0.65 per unit, for gross proceeds of \$1,000,000 and issued 96,154 units for consulting services related to the private placement. Each unit is comprised of one common share and one common share purchase warrant. The warrant will be exercisable to purchase one common share for each whole warrant at a price of \$1.00 and will expire on July 26, 2008. This transaction was effected as a private placement in accordance with Rule 506 of Regulation D promulgated under the Securities Act of 1933, as amended. We will use the net proceeds for working capital and general corporate purposes.

On September 26, 2005, we completed a private placement of 5,000,000 common shares for gross proceeds of \$2,000,000 and issued 71,250 common share purchase warrants to our placement agent. The warrants expire on September 26, 2008 and are exercisable at \$0.40 per share. This transaction was effected as a private placement in accordance with Rule 506 of Regulation D promulgated under the Securities Act of 1933, as amended.

We have incurred operating losses in the past, most recently from our continuing operations of developing security solutions. We have sustained our business during this period through the sale of common shares in a series of private placements, raising gross proceeds of \$2.0 million in September 2005, \$5 million in June/July 2006 and most recently raising \$5 million in August 2007. We cannot provide assurance that we will be able to raise sufficient funds in the future to sustain our operations.

In February 2005, the Company completed an asset sale agreement whereby it sold the majority of its subsidiary's (DSS) current assets, capital assets, current liabilities, and consultant and customer accounts for \$250,000. Diversinet is entitled to a five year annual fee of up to \$120,000 per year based on the purchaser meeting certain gross profit and net profit criteria. For the two years ending February 2006 and 2007, the annual fee has been \$nil. With the sale of DSS, we have included the results of DSS as a single line item ('discontinued operations') in the Consolidated Statements of Earnings and Deficit on a retroactive basis.

As part of the June 2006 private placement, Albert Wahbe acquired 4,600,000 units. Albert Wahbe, our chairman as of July 2006, and CEO as of April 2007, owns 5,075,000 common shares, 4,600,000 common share purchase warrants and 50,000 options, representing as of December 31, 2007 approximately 20.3% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants and options. Mr. Wahbe also entered into a performance-based consulting agreement to provide sales and business development services for the Company. Mr. Wahbe's compensation will consist solely of the issuance of 300,000 common shares of Diversinet annually and up to an additional 200,000 common shares of Diversinet annually based on meeting targets to be established by Diversinet's Board of Directors. Mr. Wahbe is entitled to Cdn\$4,000 per month in personal expenses.

During 2005 and 2006 the Company completed two financings in which Lakefront Partners, LLC and James B. Wigdale, Jr. participated. After the completion of the financings, Lakefront beneficially owned 3,909,462 common shares and 666,667 common share purchase warrants, and Mr. Wigdale owned 380,000 common shares and 1,400,000 common share purchase warrants. During the second quarter of 2007, Mr. Wigdale began performing services in a sales capacity.

### Selected Annual Information

The selected annual information presented below is based on the audited consolidated financial statements as at December 31, 2007.

For the year ended December 31	2007	2006	2005
Revenue	\$4,536,983	\$1,666,965	\$1,101,104
Loss from continuing operations	(3,432,971)	(3,450,717)	(7,038,636)

Loss for the year	(3,432,971)	(3,450,717)	(7,109,496)
Basic and diluted loss per share	(0.09)	(0.12)	(0.35)
Weighted average number of common shares	36,872,086	28,740,174	20,578,427
Dividends declared per share	—	—	—
<b>As at December 31</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Cash and cash equivalents	8,394,286	5,146,315	1,355,562
Total assets	8,960,071	5,830,228	2,013,122
Current liabilities	1,111,924	1,744,502	458,779
Total long-term liabilities	—	—	—

## Operating Results

*Year ended December 31, 2007 compared to year ended December 31, 2006*

For the years ending December 31, 2007 and 2006, we reported revenue of \$4,537,000 and \$1,667,000, respectively. We generated 92% (84% in 2006) of our revenues from the United States, 3% (12% in 2006) from the Asia Pacific region, 1% (2% in 2006) from Canada and 4% (2% in 2006) from other areas during the year ended December 31, 2007. During 2007, we generated 35% (94% in 2006) of our revenue from consulting services and 65% (6% in 2006) from licensing. With the launch of MobiSecure Wallet and Vault product suite in early 2007, we were able to increase of product license revenues compared to 2006. We currently generate our revenues from a small number of customers. The timing of signing customer contracts and the revenue recognition associated with the customer contracts results in volatility in our revenues and operating income. In December 2006 we entered into a consulting and licensing agreement with BCNEPA. During 2007, this agreement has generated revenue of \$1,000,000 for the delivery of the solution to BCNEPA, including 100,000 tokens. This agreement was terminated concurrently with the signing of the AllOne agreement. In May 2007 we entered into a license and VAR agreement to provide our MobiSecure Wallet and MobiSecure Vault mobile secure access solution to Intersections. During 2007 this agreement generated revenues of \$844,000. In August 2007 we entered into a license and revenue sharing agreement with AllOne to bundle certain software and share revenues from the sales of the combined software and a statement of work to develop certain features for the product. During 2007 these agreements have generated revenues of \$2,093,000. During 2006 we began and completed work on the RSA Security development product. We applied a zero gross margin percentage of completion method for this development agreement, providing us with \$845,000 in revenues and \$845,000 in cost of sales in fiscal 2006. During Q4 2006 we signed an agreement with BCNEPA under which we had invoiced \$900,000 included in 'deferred revenue' on the balance sheet. This agreement was terminated with the signing of the AllOne agreement, however we recognized this revenue during 2007 as we delivered the MASC license and the associated tokens to BCNEPA.

During 2007, 87% of our revenue came from three customers (78% in 2006 from three different customers). While we are endeavouring to increase our customer base, the market that we operate in is still in an evolving stage and our revenue is still quite small. Therefore, it is reasonable to expect that our revenue may continue to be concentrated among relatively few customers for the near future.

Our cost of revenues primarily represents the direct costs associated with customer support, training and implementation, and consulting services related to services performed under contract with our customers. There are no significant costs associated with the manufacturing of our software. The Company does not allocate any indirect costs such as facilities, sales commissions and administrative costs to cost of revenues. Cost of sales were \$240,000 (gross margin of 95%) for the year ended December 31, 2007 compared to \$1,041,000 (gross margin of 38%) for 2006. This represents the direct costs associated with completing the software solutions and consulting services revenue. The Company's lower cost of revenues in 2007 is the result of a higher level of license revenues in 2007. The higher level of cost of revenues and therefore lower gross margin in 2006 primarily represents the significant costs incurred to perform the consulting services with RSA Security. The Company is able to effectively redeploy its employees between its research and development projects, sales and marketing activities and customer service contracts on a continuous basis, thereby the cost of revenues only represents costs related to employees while they are actively involved in customer projects.

Research and development expenses includes compensation of software development teams working on the continuing enhancement of our products, quality assurance and testing activities as well as legal costs incurred for patent registration activities and direct administrative costs incurred by the department. The Company does not include an allocation of general operating expenses to its research and development expenses. Research and development expenses were \$2,266,000 for the year ended December 31, 2007 compared to \$832,000 for 2006. The increase in research and development costs in 2007 was largely due to the cost for outsourcing starting in January 2007 and the year over year increase of 19% in head count (from 21 to 25 people) in this department. In 2007, product developments costs of \$165,000 were reallocated from research and development to cost of sales as the development department redeployed its resources to perform professional services work to modify our products as required under our customer agreements. Costs were further reduced in 2007 by the receipt of \$87,000 from our scientific research and experimental development (SRED) claim for 2006 fiscal year. Starting in Q1 2006, the development department focused a portion of their work effort towards completing modifications to our products for RSA Security. In the past, this department's time has been spent conducting research and developing our products for general availability. During 2006, product development costs of \$730,000 were reallocated from research and development to cost of sales. Costs were further reduced in 2006 by \$288,000 from the receipt of funds for our scientific research and experimental development (SRED) claim for the 2003, 2004 and 2005 fiscal years.

Sales and marketing expenses include compensation of sales and marketing personnel, public relations and advertising, trade shows, marketing materials and direct operating expenses incurred by the sales and marketing department. The Company does not include an allocation of general operating expenses in its sales and marketing expenses. Sales and marketing expenses were \$1,781,000 for the year ended December 31, 2007 compared to \$701,000 for 2006. The increase in costs in this department was due to a 100% year over year increase in head count (from 5 to 10), as well as higher sales commissions as a result of higher revenues. Further increases

in costs included an increase in travel costs of \$102,000, and consulting services of \$212,000. Included in the December 31, 2006 sales and marketing expenses is \$33,000 relating to stock-based compensation expenses. In addition, \$107,000 of salary expense was reallocated to cost of revenues in 2006 for the RSA Security work.

General and administrative expenses include compensation expenses for corporate personnel and other general and administrative expenses such as facilities, travel and professional costs. Corporate personnel include executive officers, business development, financial planning and control, legal, human resources and corporate administrative staff. General and administrative expenses were \$3,739,000 for the year ended December 31, 2007 compared to \$2,485,000 for 2006. Included in the December 31, 2007 general and administrative expenses is \$1,543,000 (\$874,000 for 2006) relating to stock-based compensation expenses. Under GAAP, the Company is required to estimate the fair value of stock-based compensation granted to employees and to expense the fair value over the estimated vesting period of the stock options and warrant grants. Also, the year over year increase is partially due to the \$512,000 severance payment to our former CEO and \$391,000 relating to the Instant Publisher litigation settlement. During 2007, we entered into a settlement and release whereby we agreed to pay Instant Publisher \$625,000 as full and complete settlement in the matter. During 2006, the Company had accrued Cdn\$250,000 in regards to the lawsuit.

Depreciation and amortization expense was \$120,000 for the year ended December 31, 2007 compared to \$159,000 for 2006. This is consistent with the reduction in net capital assets.

Foreign exchange losses were \$71,000 for the year ended December 31, 2007 compared to \$18,000 for 2006. During 2007, the U.S./Canadian dollar exchange rate changed from approximately 1.17 to 1.01. As we have the majority of our expenses in Canadian dollars, these foreign exchange swings negatively impact our operating results. We earned interest and other income of \$246,000 during 2007 compared to \$118,000 for 2006 through investing our excess cash.

We reported a net loss for the year ended December 31, 2007 of \$3,433,000 compared to \$3,451,000 for 2006. These net losses include stock-based compensation expense relating to the issuance of options and warrants of \$1,543,000 and \$906,000 during 2007 and 2006, respectively. Due to the significant increase in our revenues, the net loss has decreased despite increased expenses. The large increase in expenses is due primarily to (i) the increase in our number of employees from 29 to 36 as the Company focuses on activities to generate and service revenues from our new product offerings, (ii) the one time severance expense of \$512,000 related to the former CEO and (iii) \$391,000 relating to litigation settlement. Loss per share for 2007 was \$0.09 compared to \$0.12 in 2006 based on a diluted weighted average of 36,872,000 and 28,740,000 common shares, respectively.

*Unaudited quarter ended December 31, 2007 compared to the unaudited quarter ended December 31, 2006*

For the quarter ending December 31, 2007, we reported revenue of \$1,352,000 compared to \$286,000 for the quarter ended December 31, 2006. During the quarter, we generated 23% (70% in 2006) of our revenue from consulting services and 77% (30% in 2006) from licensing. The higher revenue for the 2007 quarter was due to the delivery of tokens to AllOne under the license and revenue agreement, representing \$1 million in revenues. During Q4 2006 we signed an agreement with BCNEPA under which we had invoiced \$900,000 (and received \$900,000) which invoiced amount is included in 'deferred revenue' on the balance sheet.

Cost of sales were \$73,000 (gross margin of 95%) for the quarter ended December 31, 2007 compared to \$50,000 (gross margin of 83%) for the same quarter in 2006. The increase is due to the allocation of development costs to cost of sales related to the redeployment of employees to complete customer projects. The work done for RSA Security during 2006 was completed during Q3 2006, resulting in a drop in costs allocated to cost of sales during Q4 2006.

Research and development expenses were \$696,000 for the quarter ended December 31, 2007 compared to \$316,000 for the same period of 2006. The Q4 2007 results include outsourcing development costs of \$50,000, an increase of the headcount from 21 to 25 and an employee bonus accrual of \$250,000. Sales and marketing expenses were \$801,000 for the quarter ended December 31, 2007 compared to \$189,000 for the same period of 2006. The increase in sales and marketing expenses in Q4 2007 was due primarily to: the increase in the number of employees from 3 to 8, \$236,000 paid in commission based on higher revenues and \$96,000 paid in consulting services. The Q4 2007 general and administrative expenses were \$1,181,000 compared to \$797,000 for the same period in 2006. The 2007 quarter includes \$794,000 in stock based compensation compared to \$90,000 for the same period in 2006. The Q4 2006 also includes Canadian \$250,000 in litigation costs related to the Instant Publisher lawsuit.

Depreciation and amortization expense was \$33,000 for the quarter ended December 31, 2007 compared to \$38,000 for the same period of 2006. The variance is the result of applying our rates to a declining net asset balance.

We reported a net loss of \$1,326,000 for the quarter ended December 31, 2007 compared to \$1,050,000 for the quarter ended December 31, 2006. The loss per share was \$(0.03) for the quarter ended December 31, 2007 and quarter ended December 31, 2006 based on a diluted weighted average of 42,075,000 and 32,370,000 common shares, respectively.

*Year ended December 31, 2006 compared to year ended December 31, 2005*

For the years ending December 31, 2006 and 2005, we reported revenue of \$1,667,000 and \$1,101,000, respectively. We generated 84% (73% in 2005) of our revenues from the United States, 12% (18% in 2005) from the Asia Pacific region, 2% (9% in 2005) from Canada and 2% (nil in 2005) from other areas during the year ended December 31, 2006. During 2006, we generated 94% (100% in 2005) from consulting services and 6% (nil in 2005) from licensing. During 2006 we began and completed work on the RSA Security development product. We applied a zero gross margin percentage of completion method for this development agreement, providing us with \$845,000 in revenues and \$845,000 in cost of sales in fiscal 2006. During Q4 2006 we signed an agreement with BCNEPA under which we have invoiced \$900,000 included in 'deferred revenue' on the balance sheet. We expect to commence recognition of revenue related to this arrangement over the coming quarters as we deliver the MASC license and the associated 100,000 tokens to BCNEPA.

In January 2005 Diversinet began to focus on the evolving protection and trust needs of mobile users. These financial results reflect this shift in focus and the time required to build up a customer base under this new strategy, and a rebuilding of the sales and marketing strategy of the company. During the third quarter of 2005 we received notice from one of our customers that they would not be renewing our contract to provide test lab services. This contract represented \$479,000 in 2005 revenues.

During 2006, 78% of our revenue came from three customers (67% in 2005 from two different customers). While we are endeavouring to increase our customer base, the market that we operate in is still in an evolving stage and our revenue is still quite small. Therefore, it is reasonable to expect that our revenue may continue to be concentrated among relatively few customers for the near future.

Cost of sales were \$1,041,000 (gross margin of 38%) for the year ended December 31, 2006 compared to \$563,000 (gross margin of 49%) for 2005. This represents the direct costs associated with completing the software solutions and consulting services revenue. The lower margin for 2006 is the result of lower margins on a significant strategic customer (RSA Security) in 2006.

Research and development expenses were \$832,000 for the year ended December 31, 2006 compared to \$1,242,000 for 2005. Starting in Q1 2006, the development department focused a portion of their work effort towards completing modifications to our products for RSA Security. In the past, this department's time has been spent conducting research and developing our products for general availability. As a result, during 2006, product development costs of \$730,000 were reallocated from research and development to cost of sales. Costs were further reduced in 2006 by \$288,000 from the receipt of funds for our scientific research and experimental development (SRED) claim for the 2003, 2004 and 2005 fiscal years. The increase in development costs of \$608,000 (before the SRED credit and cost of sales allocation) over 2005 was largely due to an increase of 31% in the head count (from 16 to 21 people) in this department.

Sales and marketing expenses were \$701,000 for the year ended December 31, 2006 compared to \$1,290,000 for 2005. The decrease in costs in this department was due to a 38% reduction in the average head count (from 8 to 5). Further cost reductions included a decrease in travel costs of \$46,000, conferences by \$40,000 and memberships by \$28,000. Included in the December 31, 2006 sales and marketing expenses is \$33,000 (\$nil for 2005) relating to stock-based compensation expenses.

General and administrative expenses were \$2,485,000 for the year ended December 31, 2006 compared to \$2,301,000 for 2005. Included in the December 31, 2006 general and administrative expenses is \$874,000 (\$986,000 for 2005) relating to stock-based compensation expenses. The Company is required to estimate the fair value of stock-based compensation granted to employees and to expense the fair value over the estimated vesting period of the stock options and warrant grants. Professional fees increased by \$76,000 over 2005 due to greater spending in investor and public relations areas. We have also accrued Canadian \$250,000 with regards to litigation costs that we are currently involved in.

Depreciation and amortization expense was \$159,000 for the year ended December 31, 2006 compared to \$540,000 for 2005. The reduction in 2006 is primarily due to the sale of the DSS assets in February 2005, which led to reduced depreciation and amortization. This is consistent with the reduction in net capital assets.

Foreign exchange losses were \$18,000 for the year ended December 31, 2006 compared to \$11,000 for 2005. We earned interest and other income of \$118,000 during 2006 compared to \$32,000 for 2005 through investing our excess cash.

We reported a loss from discontinued operations of \$nil for the year ended December 31, 2006 compared to \$71,000 for 2005. In February 2005 DSS completed an agreement whereby it sold the majority of its current assets, capital assets, current liabilities, consultant and customer accounts for \$250,000. With the sale of the DSS assets, we have included the results of DSS as a single line item ('discontinued operations') in the financial statements. During the first quarter of 2005, with the sale of DSS' assets, goodwill from the acquisition of DSS of \$392,000 has been included in determining the loss on disposition.

We reported a net loss for the year ended December 31, 2006 of \$3,451,000 compared to \$7,109,000 for 2005. These net losses include stock-based compensation expense relating to the issuance of options and warrants of \$906,000 and \$986,000 during 2006 and 2005, respectively, and a goodwill and customer asset impairment charge of \$nil and \$2,225,000 for 2006 and 2005, respectively. Loss per share for 2006 was \$0.12 compared to \$0.35 in 2005 based on a diluted weighted average of 28,740,000 and 20,578,000 common shares, respectively.

## **Liquidity and Capital Resources**

*Year ended December 31, 2007 compared to year ended December 31, 2006*

Cash and cash equivalents at December 31, 2007 were \$8,394,000 compared with \$5,146,000 at December 31, 2006. The net change in cash and cash equivalents for 2007 was \$3,248,000 compared to \$3,791,000 for 2006. The fiscal 2007 increase was largely due to the \$5,000,000 BCNEPA private placement discussed below. This was offset by operating activities which used cash in an amount of \$2,200,000, including the reversal of \$808,000 in deferred revenues from the recognition of the Q4 2006 BCNEPA cash receipt of \$900,000 into revenues in 2007. The fiscal 2006 increase was largely due to the June and July private placements in which aggregate gross proceeds of \$5,008,000 were raised. This was offset by operating activities which used cash in an amount of \$1,210,000 which includes the receipt from BCNEPA of \$900,000 included as part of the deferred revenues. Cash used in investing activities for 2007 and 2006 is solely the result of the purchase of capital assets of \$111,000 and \$75,000, respectively.

In August 2007 we completed a private placement of 6,756,757 Diversinet common shares to BCNEPA at \$0.74 per share, for gross proceeds of \$5,000,000.

On July 26, 2006, we completed a private placement of 1,538,463 units, at \$0.65 per unit, for gross proceeds of \$1,000,000 and issued 96,154 units for consulting services related to the private placement. Each unit is comprised of one common share and one common share purchase warrant. The warrant will be exercisable to purchase one common share for each whole warrant at a price of \$1.00 and will expire on July 26, 2008.

On June 30, 2006, we completed a private placement of 6,680,001 units, at \$0.60 per unit, for gross proceeds of \$4,008,000. Each unit is comprised of one common share and one common share purchase warrant. One half of the warrant will be exercisable to purchase one common share for each whole warrant at a price of \$0.75, the other half warrant at \$0.90, and will expire on June 30, 2008.

As of December 31, 2007, we had commitments under non-cancellable operating leases for our facilities and equipment through 2012 in amounts of \$1,045,000.

We are not subject to material market risk exposures, except for risks related to interest rate fluctuations and foreign currency exchange rates. Our exposure to market rate risk for changes in interest rates relates primarily to our cash equivalents and short-term investments, created by our past financings. We have not used derivative financial instruments in our short-term investments. We invest in high quality money market instruments and bonds with terms of less than 90 days. We are averse to principal loss and ensure the safety and preservation of our invested funds by limiting default, market and reinvestment risk. We do not make use of a bank line of credit and do not have any long-term debt. The impact of inflation has not been material to our business over the past five years.

We believe that our cash and cash equivalents as at December 31, 2007 of \$8,394,000 is sufficient to meet our short-term working capital requirements for the next twelve months. We may need to raise additional amounts to meet our working capital requirements through private or public financings, strategic relationships or other arrangements. However, additional funding may not be available on terms attractive to us, or at all. If we enter into strategic relationships to raise additional funds, we may be required to relinquish rights to certain of our technologies. Our failure to either raise capital when needed or to generate revenues could leave us with insufficient resources in the future to sustain our operations beyond the next twelve months.

The following table presents unaudited selected financial data for each of the last eight quarters ending December 31, 2007:

	Revenue for the period (\$000's)	Loss for the period (\$000's)	Loss per share (\$)
December 31, 2007	1,352	1,326	0.03
September 30, 2007	1,262	730	0.02
June 30, 2007	1,017	1,045	0.03
March 31, 2007	905	331	0.01
December 31, 2006	285	1,050	0.03
September 30, 2006	432	932	0.03
June 30, 2006	477	747	0.03
March 31, 2006	473	722	0.03

*Quarter ended December 31, 2007 compared to quarter ended December 31, 2006*

The net change in cash and cash equivalents for the fourth quarter of 2007 was \$(524,000) compared to \$356,000 for the fourth quarter of 2006. The Q4 2007 decrease includes the \$625,000 litigation settlement payment with Instant Publisher. The Q4 2006 increase is largely due cash receipts of \$900,000 received under the BCNEPA agreement. This amount was recorded in deferred revenue and has been recognized as revenue in 2007.

*Year ended December 31, 2006 compared to year ended December 31, 2005*

Cash and cash equivalents at December 31, 2006 were \$5,146,000 compared with \$1,356,000 at December 31, 2005. The net change in cash and cash equivalents and short term investments for 2006 was \$3,791,000 compared to \$(1,368,000) for 2005. The fiscal 2006 increase was largely due to the June and July private placements in which gross proceeds of \$5,008,000 were raised. This was offset by operating activities which used cash in an amount of \$1,210,000 which includes the receipt from BCNEPA of \$900,000 included as part of the deferred revenues. The fiscal 2005 decrease is mainly due to continuing operations which used cash in an amount of \$3,291,000, offset by financing completed during 2005 for gross proceeds of \$2,000,000.

On July 26, 2006, we completed a private placement of 1,538,463 units, at \$0.65 per unit, for gross proceeds of \$1,000,000 and issued 96,154 units for consulting services related to the private placement. Each unit is comprised of one common share and one common share purchase warrant. The warrant will be exercisable to purchase one common share for each whole warrant at a price of \$1.00 and will expire on July 26, 2008.

On June 30, 2006, we completed a private placement of 6,680,001 units, at \$0.60 per unit, for gross proceeds of \$4,008,000. Each unit is comprised of one common share and one common share purchase warrant. One half of the warrant will be exercisable to purchase one common share for each whole warrant at a price of \$0.75, the other half warrant at \$0.90, and will expire on June 30, 2008.

On September 26, 2005, we completed a private placement of 5,000,000 common shares for gross proceeds of \$2,000,000 and issued 71,250 common share purchase warrants to our placement agent. Each warrant entitles the holder to acquire one common share at a price of \$0.40 per common share for a period of three years starting September 26, 2005. During 2005 the Board approved an incentive plan, based on achievement of certain milestones, for the entire management team and employees consisting of up to \$2,000,000 in cash and 2,000,000 nominal value warrants.

As of December 31, 2006, we had commitments under non-cancellable operating leases for our facilities and equipment through 2012 in amounts of \$1,098,000.

### Disclosure Controls and Procedures

We carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the fiscal year covered by this Annual Report. This evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in our corporate filings is recorded, processed, summarized and reported within the required time periods.

In connection with the evaluation referred to in the foregoing paragraph, we have identified no change in our disclosure controls and procedures that occurred during the year ended December 31, 2007 that has materially affected, or is reasonably likely to materially affect, our disclosure controls over financial reporting

### Internal Control over Financial Reporting

Management has assessed the design and effectiveness of internal controls over financial reporting as at December 31, 2007, and based on that assessment determined that internal controls over financial reporting were designed and operating effectively to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. No changes were made to the design of the Company's internal controls over financial reporting during the quarter December 31, 2007, that has materially affected, or is reasonably likely to materially affect, the design of our internal controls over financial report

### Off-balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have had, or are reasonably likely to have, a current or future effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

### Tabular Disclosure of Contractual Obligations

We are committed under operating leases for a total amount of approximately \$1,045,019. The minimum payments due in each of the following years are as follows:

Contractual obligations	Total	Less than 1 year	2-3 years	4-5 years	More than 5 years
Operating lease obligations	1,045,019	248,753	477,760	318,506	–
Total	\$1,045,019	\$248,753	\$477,760	\$318,506	–

### Transactions with Related Parties

During the second quarter of 2007 Albert Wahbe was appointed Chief Executive Officer pursuant to a one year consulting agreement renewable for a further one year period at the discretion of the Board of Directors. Mr. Wahbe's compensation will consist solely of the issuance of 300,000 common shares of Diversinet annually and up to an additional 200,000 common shares of Diversinet annually based on meeting targets to be established by Diversinet's Board of Directors. Mr. Wahbe is entitled to Cdn\$4,000 per month in personal expenses. During 2007 he received 375,000 common shares and Cdn\$36,000 relating to this agreement. As part of the June 2006 private placement, Mr. Wahbe acquired 4,600,000 units. As of December 31, 2007, Albert Wahbe owns 5,075,000 common shares, 4,600,000 common share purchase warrants and 50,000 options, representing approximately 20.3% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants and options.

During January 2007 and December 2007, James Wigdale, Jr., one of our Directors, exercised 350,000 warrants (at \$0.60 per share) and 300,000 warrants (at \$0.40 per share) respectively, into common shares. Furthermore, an additional 750,000 held by Mr. Wigdale (at \$2.00 and \$2.05 per share) expired unexercised. During the second quarter of 2007, Mr. Wigdale began performing services in a sales capacity. During 2007 the Company paid Mr. Wigdale \$52,500 and issued him 56,250 common shares relating to his consulting agreement. Additionally, 25,000 common shares and 50,000 options were issued to Mr. Wigdale as Director compensation in 2007. As part of the June 2006 private placement, Lakefront Partners, LLC, a company controlled by Mr. Wigdale, acquired 666,667 units. As well, during the September 2005 private placement, Lakefront Partners, LLC acquired 725,000 common shares. In 2004 we completed two financings in which Lakefront Partners, LLC and Mr. Wigdale participated. As at December 31, 2007, Lakefront Partners, LLC owns 3,909,462 common shares and 666,667 common share purchase warrants, and Mr. Wigdale owns 1,111,250 common shares and 50,000 options, together representing approximately 13.1% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants and options.

As part of the August 2007 private placement, BCNEPA acquired 6,756,757 common shares. In October 2007, BCNEPA received 100,000 common shares in regards to compensation for William Reed's participation on the Diversinet Board of Directors. As at December 31, 2007, BCNEPA owns 6,756,757 common shares representing approximately 15.9% of the issued and outstanding common shares of the Company.

### Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Significant estimates are used in determining, but not limited to, the allowance for doubtful accounts, income tax valuation allowances, stock based

compensation, the useful life of depreciable assets and the recoverability of fixed assets. In making such estimates and assumptions, management consults with employees knowledgeable in the area; gathers relevant information; where appropriate, seeks advice from qualified third parties, and, makes judgments, which in their opinion at the time, represent fair, balanced and appropriate conservative estimates and assumptions. Actual results could differ from those estimates.

#### *Allowance for doubtful accounts*

The Company has an accounts receivable balance of \$123,000 at December 31, 2007 (2006 – \$154,000). The valuation of accounts receivable requires significant estimates to be made by management and the valuation of these balances could have an impact on the Company's consolidated financial statements. These accounts receivable are comprised of amounts arising from contractual arrangements with major health care, identity management, financial and mobile network and security service providers. The Company determines an allowance for doubtful accounts based on knowledge of the financial conditions of its customers, the aging of the receivables, customer and industry concentrations, the current business environment and historical experience. At December 31, 2007, management has consistently applied this methodology and the Company has had a history of minimal bad debt loss. A change in any of the factors impacting the estimate of the allowance for doubtful accounts will directly impact the amount of bad debt expense recorded in general and administrative expenses.

#### *Income tax estimates*

Management continually reviews the estimates of the valuation of future income tax assets. This involves the use of judgment in the estimation of future income projections, actual tax exposures, assessing temporary differences that result from differing treatments in items for accounting purposes versus tax purposes, and in estimating the recoverability of the benefits arising from tax loss carry-forwards. The Company is required to assess whether it is more likely than not that future income tax assets will be realized prior to the expiration of the related tax loss carry forwards.

Changes in the forecasts of future profitability, the utilization of income tax loss carry forwards, the valuation allowance, and changes in tax rates could have a material impact on the reported amounts for future income tax assets and future income tax expense. The Company currently has a 100% valuation allowance against its future tax assets.

#### *Stock based compensation*

The Company records stock based compensation expense over the vesting period of the options based on the estimated fair value of the stock options granted. The Company's policy is to determine the exercise price of an option based on the average trading price for five days prior to the grant. The Company uses the Black-Scholes option pricing model to estimate the fair value of stock options on the grant date and the amount is expensed over the vesting period of the stock options. The assumptions used in the calculation of fair value include the risk free interest rate, dividend yield, volatility factor and expected life of the options.

The risk free interest rate is based on the then current risk free interest rate for the expected life of the option. The dividend yield is based on the Company's historical practice of dividend payments. The volatility factor is based on analysis of the history of the Company's share price and management's estimate of the expected volatility over the respective terms of the options. The expected life of the option is based on the expected length of time options are estimated to remain outstanding.

#### *Useful lives of depreciable assets*

The Company depreciates the cost of fixed assets over their respective estimated useful lives. These estimates of useful lives involve estimation and judgment. In determining the estimates of useful lives, the Company considers industry trends and changing technologies. On an annual basis, the Company reassesses the estimated useful lives to ensure they correspond with the anticipated life of the respective assets. If a technological change happens more quickly than anticipated, the Company may have to revise the estimates of useful lives of fixed assets which could result in higher depreciation expense in future periods or an impairment charge to write-down the value of the fixed assets.

#### *Recoverability of long-lived assets*

Long lived assets, including fixed assets and intangible assets with finite useful lives, are depreciated over their estimated useful lives. The Company reviews for impairment annually, or more frequently, if events or changes in circumstances indicate that the carrying amount may not be recoverable. If the sum of undiscounted cash flows expected to result from the use and eventual disposition of a group of assets is less than its carrying amount, it is considered to be impaired. These analyses involve estimates of future cash flows and estimated periods of use. If the undiscounted net cash flows associated with a group of long-lived assets exceed the carrying amounts, impairment losses are measured as the excess of the carrying amount over the fair value

In the year ended December 31, 2007, we did not make any significant changes in, nor take any corrective actions regarding, our internal controls or other factors that could significantly affect these estimates. We periodically review our internal controls for effectiveness and we plan to conduct an evaluation of our disclosure controls and procedures each quarter. Other important accounting policies are described in note 1 to our consolidated financial statements.

### **Adoption of New Accounting Pronouncements**

In 2005, The Canadian Institute of Chartered Accountants ("CICA") issued Handbook Section 3855, Financial Instruments – Recognition and Measurement ("Section 3855"), Handbook Section 1530, Comprehensive Income ("Section 1530"), Handbook Section 3251, Equity ("Section 3251"), and Handbook Section 3865, Hedges ("Section 3865"). The new standards are effective for the Company's interim and annual financial statement commencing January 1, 2007. Section 1530 establishes standard for reporting and presenting comprehensive income, which is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income that are excluded from net income calculated in accordance with generally accepted accounting principles. Under the new standards, policies followed for periods prior to

the effective date generally are not reversed and therefore, the comparative figures have not been restated. The adoption of these new standards had no impact on opening deficit as of January 1, 2007.

Under Section 3855, financial instruments must be classified in one of these five categories: i) held-for-trading; ii) loans and receivables; iii) held-to-maturity; iv) available for sale; or v) other financial liabilities. All financial instruments, including derivatives, are measured in the balance sheet at fair value except for loans and receivables, held-to maturity investments and other financial liabilities which are measured at amortized cost. Subsequent measurement and changes in fair value will depend on their initial classification, as follows: held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net income; and available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the investment is derecognized or impaired at which time the amounts would be recorded in net income.

Upon adoption of the new standards, the Company has designated its cash and cash equivalents as held-for-trading which are measured at fair value with changes recorded in the consolidated statement of earnings and deficit as interest income. Accounts receivable are classified as loans and receivables, which are measured at amortized cost and consistent to the Company's accounting policy prior to the adoption of section 3855. Accounts payable and accrued liabilities have been classified as other financial liabilities, which are accounted for at amortized cost using the effective interest method. Given the current nature of the Company's accounts receivable and payable balances, the impact of discounting using the effective interest rate method would not result in significantly different amounts than carrying value. The Company had no held-to-maturity or available for sale financial assets during the year ended December 31, 2007.

Transaction costs that are directly attributable to the acquisition or issuance of financial assets or liabilities are accounted for as part of the respective asset or liability's carrying value at inception.

The Company reviewed significant contracts in effect on January 1, 2007 and during the year ended December 31, 2007 and determined that there are no significant embedded derivatives or non-financial derivatives that require separate fair value recognition on the consolidated balance sheet on the transition date of January 1, 2007 or at December 31, 2007.

Disclosure of comprehensive income/(loss) was added to the Company's consolidated financial statements. The Company had no comprehensive income/(loss) transactions during the year ended December 31, 2007. For all periods presented, there is no difference between the Company's comprehensive income/(loss) and loss for the year. The adoption of these standards had no impact on the Company's loss for the year ended December 31, 2007. Accumulated other comprehensive income forms part of shareholders' equity.

In December 2006, the CICA issued Handbook Section 3862, Financial Instruments - Disclosures, and Handbook Section 3863, Financial Instruments – Presentation. These new standards will become effective for the Company beginning January 1, 2008. The Company is currently assessing the impact of these two new standards on its consolidated financial statements.

#### **Recently Issued Pronouncements:**

In December 2006, the CICA issued Handbook Section 1535, Capital Disclosures, which provides standards for disclosures regarding a company's capital and how it is managed. Enhanced disclosure with respect to the objectives, policies and processes for managing capital and quantitative disclosures about what a company regards as capital is required. These recommendations are effective for fiscal years beginning on or after October 1, 2007 and, therefore, the Company will be required to implement these standards on January 1, 2008. The Company is evaluating the impact of this standard on its consolidated financial statements

#### **Risks and Uncertainties**

Our Company is subject to a number of risks and uncertainties that could cause actual results to differ materially from those predicted or anticipated. These risks are described in our F-3 and annual Form 20-F filed with the SEC in the United States at [www.sec.gov](http://www.sec.gov) and filed on SEDAR in Canada at [www.sedar.com](http://www.sedar.com). We encourage you to review these filings in order to evaluate an investment in our securities. Some key risks that could cause actual results to differ materially from those predicted or anticipated are listed below.

**Financial resources:** The attached consolidated financial statements are prepared on a going concern basis that assumes that the Company will continue in operation in the foreseeable future and be able to realize its assets and discharge its liabilities in the normal course of business. Although we have made progress in developing our solutions and have completed initial consumer deployments, our revenue from operations is not sufficient to cover our operating expenses at present and is unlikely to be sufficient within fiscal 2008. We have historically obtained funding for operations from private placements, but there is no assurance we will be able to do so again in the future or on terms favourable to the Company, despite the progress of the business. Our failure to either raise capital when needed or to generate revenues would leave us with insufficient resources to continue our business.

**Variability of performance:** Our quarterly and annual operating results have varied substantially in the past and are likely to vary substantially from quarter to quarter and year to year in the future due to a variety of factors. In particular, our period-to-period operating results are significantly dependent upon the sale of license agreements and the continued success in providing professional services. In this regard, the purchase of our solutions often requires our customers to make a significant capital investment, which customers may view as a discretionary cost and, therefore, a purchase that can be deferred or cancelled due to budgetary or other business reasons. Furthermore, our ability to continue providing professional services is dependent upon being able to provide value added resources at reasonable rates. Estimating future revenues is also difficult because we ship our products upon receipt of a signed license agreement and, therefore, we do not have a backlog. Thus, quarterly and annual license revenues are heavily dependent upon agreements finalized and software shipped within the same quarter or year. We expect these revenue patterns to continue for the foreseeable future, until recurring revenue becomes a significant portion of total revenue. Despite the uncertainties in our revenue patterns, our operating expenses are based upon anticipated revenue levels and such expenses are incurred on an

approximately rateable basis throughout the quarter. As a result, if expected revenues are delayed or otherwise not realized in a quarter for any reason, our business, operating results and financial condition would be adversely affected in a significant way.

Liquidity of our common shares: If our common shares should become ineligible for continued quotation on the Over the Counter Bulletin Board or a public trading market does not continue for any reason, holders of our common shares may have difficulty selling their shares. Our common shares became ineligible for continued quotation on the NASDAQ SmallCap Market and are now trading on the Over the Counter Bulletin Board; therefore holders of our common shares will have difficulty selling their shares. Our common shares were quoted on the NASDAQ SmallCap Market from June 1995 through late April 2003. Our common shares may continue to be penny stock, which may adversely affect the liquidity of our common shares. The United States Securities and Exchange Commission has adopted regulations that define a penny stock to be any equity security that has a market price, as defined in those regulations, of less than \$5.00 per share, subject to certain exceptions. Our common shares are currently penny stock.

Commercial deployment: The ability of the Company to continue operations is also dependent on the acceptance of its security and identity management solutions and the adoption of transaction-based applications over wireless networks as an accepted method of commerce in sufficient volume for us to generate enough revenues to fund our expenses and capital requirements. The wireless mobile commerce market is in a very early stage and it may not develop to a sufficient level to support our business.

Dependence on key customers; concentration of credit: The loss of any key customer and our inability to replace revenues provided by a key customer may have a material adverse effect on our business and financial condition. Our customer base includes large financial institutions and security providers. As a result, we maintain individually significant receivable balances due from them. If these customers fail to meet their payment obligations, our operating results and financial condition could be adversely affected. As at December 31, 2007, three customers accounted for 46%, 22% and 19% of our total 2007 consolidated revenues.

Foreign exchange: Our functional currency is the U.S. dollar. Sales generated outside Canada are generally denominated in U.S. dollars. During the fiscal 2007, we incurred a portion of our expenses in U.S. dollars and Canadian dollars. Changes in the value of the Canadian currency relative to the U.S. dollar may result in currency losses that may have an adverse effect on our operating results. During fiscal 2007 and 2006 we maintained a portion of our cash resources in both U.S. and Canadian dollar term deposits. The Company does not have any foreign currency derivative instruments outstanding at December 31, 2007.

Litigation: Our Company has previously been named as a defendant in various proceedings arising in the course of our Company's activities and arising from transactions relating to a previous business operated by our Company. Litigation arising from these matters may be time consuming, distracting and expensive. An adverse resolution to any of these proceedings may have a material adverse impact on our business and financial condition. During fiscal 2000, the Company and its wholly owned Barbados subsidiary, The Instant Publisher Ltd., were sued by a company that alleged that the Company breached a dealer agreement entered into in 1995 by the Company's former printing business and is seeking damages of \$1,533,950 and damages of \$25,000,000 for loss of reputation and loss of opportunity, pre-judgment and post-judgment interest, and costs. During October 2007, the parties entered into a settlement and release whereby the Company agreed to pay the plaintiff \$625,000 as full and complete settlement in the matter, including a court order dismissing the case.

## MANAGEMENT'S REPORT

The accompanying consolidated financial statements and all information in the Annual Report have been prepared by management and have been reviewed and approved by the Board of Directors of the Company. The consolidated financial statements were prepared in accordance with accounting principles generally accepted in Canada and, where appropriate, reflect management's best estimates and judgments. Management is responsible for the accuracy, integrity and objectivity of the consolidated financial statements within reasonable limits of materiality and for the consistency of financial data included in the text of the Annual Report with that contained in the consolidated financial statements.

To assist management in the discharge of these responsibilities, the Company maintains a system of internal controls and systems designed to provide reasonable assurance that its assets are safeguarded, that only valid and authorized transactions are executed and that accurate, timely and comprehensive financial information is prepared and disclosed. The internal control systems and financial records are subject to reviews by external auditors during the examination of the financial statements. Management recognizes its responsibility for conducting the Company's affairs to comply with the requirements of applicable laws and established financial standards and principles, and for maintaining proper standards of conduct in its activities.

The Company's Audit Committee is appointed by the Board of Directors annually and is comprised of three non-management directors. The Audit Committee meets with management as well as with the independent auditors to satisfy itself that management is properly discharging its financial reporting responsibilities and to review the consolidated financial statements and the independent auditors' report. The Audit Committee reports its findings to the Board of Directors for consideration in approving the consolidated financial statements for presentation to the shareholders. The Audit Committee has responsibility for engaging or re-appointing the Company's independent auditors. The independent auditors have direct and unrestricted access to the Audit Committee to discuss their audit and related findings as to the integrity of the Company's financial reporting.

The consolidated financial statements have been audited by KPMG LLP, Chartered Accountants, Licensed Public Accountants, on behalf of the shareholders, in accordance with generally accepted auditing standards. Their report outlines the scope of their audit and expresses their opinion on the consolidated financial statements of the Company.



Albert Wahbe, *Chief Executive Officer*  
February 22, 2008



David Hackett, *Chief Financial Officer*

## AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Diversinet Corp. as at December 31, 2007 and 2006 and the consolidated statements of earnings, comprehensive income (loss) and deficit and cash flows for each of the years in the three year period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards and the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2007 and 2006 and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2007 in accordance with Canadian generally accepted accounting principles.

Canadian generally accepted accounting principles vary in certain significant respects from US generally accepted accounting principles. Information relating to the nature and effect of such differences is presented in Note 14 to the consolidated financial statements.



Chartered Accountants, Licensed Public Accountants  
Toronto, Canada  
February 22, 2008

# DIVERSINET CORP.

Consolidated Balance Sheets  
(In United States dollars)

As at December 31	2007	2006
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 8,394,286	\$ 5,146,315
Accounts receivable (note 3)	122,687	154,109
Prepaid expenses	63,105	141,081
Total current assets	8,580,078	5,441,505
Capital assets, net (note 4)	379,993	388,723
Total assets	\$ 8,960,071	\$ 5,830,228

## Liabilities and Shareholders' Equity

Current liabilities:		
Accounts payable	\$ 249,502	\$ 172,291
Accrued liabilities (note 5)	731,461	633,661
Deferred revenue	130,961	938,550
Total current liabilities	1,111,924	1,744,502

### Shareholders' equity:

Share capital (note 6):		
Authorized:		
Unlimited common shares		
Issued and outstanding:		
43,167,783 (33,413,005 – 2006)		
common shares	65,370,707	58,414,036
Contributed surplus	5,621,383	3,646,283
Share purchase warrants (note 6)	1,555,453	3,291,832
Deficit	(63,178,675)	(59,745,704)
Accumulated other comprehensive income:		
Cumulative translation adjustment	(1,520,721)	(1,520,721)
Total shareholders' equity	7,848,147	4,085,726

### Commitments and contingencies (note 10)

Total liabilities and shareholders' equity	\$ 8,960,071	\$ 5,830,228
--	--------------	--------------

See accompanying notes to consolidated financial statements.

On behalf of the Board:



Albert Wahbe, Chairman



Greg Milavsky, Director

# DIVERSINET CORP.

Consolidated Statements of Earnings, Comprehensive Income (Loss) and Deficit  
(In United States dollars)

Year ended December 31	2007	2006	2005
Revenue	\$ 4,536,983	\$ 1,666,965	\$ 1,101,104
Cost of sales	239,878	1,041,096	562,987
Gross margin	4,297,105	625,869	538,117
Expenses:			
Research and development	2,265,755	831,925	1,241,599
Sales and marketing	1,780,991	700,870	1,289,940
General and administrative	3,738,545	2,484,556	2,301,032
Depreciation and amortization	119,647	159,048	539,770
Goodwill impairment charge (note 1d)	-	-	1,894,690
Customer asset impairment charge	-	-	330,768
	7,904,938	4,176,399	7,597,799
Loss before the following	(3,607,833)	(3,550,530)	(7,059,682)
Foreign exchange loss	71,106	18,291	10,586
Interest income and other income	(245,968)	(118,104)	(31,632)
Loss from continuing operations	(3,432,971)	(3,450,717)	(7,038,636)
Loss from discontinued operations (note 2)	-	-	(70,860)
Loss for the year and comprehensive loss	(3,432,971)	(3,450,717)	(7,109,496)
Deficit, beginning of year	(59,745,704)	(56,294,987)	(49,185,491)
Deficit, end of year	\$(63,178,675)	\$(59,745,704)	\$(56,294,987)
Basic and diluted loss per share from continuing operations	\$ (0.09)	\$ (0.12)	\$ (0.34)
Basic and diluted loss per share (note 7)	\$ (0.09)	\$ (0.12)	\$ (0.35)
Weighted average number of common shares	36,872,086	28,740,174	20,578,427

See accompanying notes to consolidated financial statements.

# DIVERSINET CORP.

Consolidated Statements of Cash Flows  
(In United States dollars)

For the year ended December 31	2007	2006	2005
Cash provided by (used in):			
Operating activities:			
Loss for the year from continuing operations	\$ (3,432,971)	\$ (3,450,717)	\$ (7,038,636)
Items not involving cash:			
Depreciation and amortization	119,647	159,048	539,770
Goodwill impairment charge (note 1d)	—	—	1,894,690
Customer asset impairment charge	—	—	330,768
Stock-based compensation expense	1,542,743	906,444	986,257
	(1,770,581)	(2,385,225)	(3,287,151)
Change in non-cash operating working capital:			
Accounts receivable	31,422	(86,804)	258,634
Prepaid expenses	77,976	(23,836)	70,408
Accounts payable	77,211	19,191	6,016
Accrued liabilities	190,900	406,982	(252,102)
Deferred revenue	(807,589)	859,550	(86,343)
Cash used in continuing operations	(2,200,661)	(1,210,142)	(3,290,538)
Cash provided by discontinued operations	—	—	(92,042)
Cash used in operations	(2,200,661)	(1,210,142)	(3,382,580)
Financing activities:			
Issue of common shares, common share purchase options and warrants for cash	5,559,548	5,075,656	1,842,183
Notes payable	—	—	(4,611)
Proceeds from sale of discontinued operations	—	—	250,000
Cash provided by financing activities	5,559,548	5,075,656	2,087,572
Investing activities:			
Proceeds of disposition of short-term investments	—	—	2,000,000
Capital assets additions	(110,917)	(74,761)	(72,928)
Cash provided by (used in) investing activities	(110,917)	(74,761)	1,927,072
Increase in cash and cash equivalents	3,247,970	3,790,753	632,064
Cash and cash equivalents, beginning of year	5,146,315	1,355,562	723,498
Cash and cash equivalents, end of year	\$ 8,394,286	\$ 5,146,315	\$ 1,355,562
Supplemental cash flow information:			
Interest received	245,968	118,104	31,632
Supplemental disclosure relating to non-cash financing and investing activities:			
Issuance of shares to employees	516,409	84,543	—
Issuance of shares for public relations services	61,545	—	—
Cash and cash equivalents is comprised of :			
Cash	857,609	674,421	235,391
Cash equivalents	7,536,677	4,471,894	1,120,171
	\$ 8,394,286	\$ 5,146,315	1,355,562

See accompanying notes to consolidated financial statements.

# DIVERSINET CORP.

Notes to Consolidated Financial Statements  
(In United States dollars)

Years ended December 31, 2007, 2006, and 2005

Diversinet Corp. (the "Company"), an Ontario corporation, develops, markets and distributes wireless security infrastructure solutions and identity management solutions and professional services to the health services, financial services, software security, storage and memory manufacturers, entertainment and gaming and telecommunications marketplaces.

## 1. Significant accounting policies:

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada, which, except as described in note 14, conform in all material respects with accounting principles generally accepted in the United States. Significant accounting policies adopted by the Company are as follows:

### (a) Basis of consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany transactions and balances have been eliminated.

### (b) Adoption of new accounting standards:

In 2005, The Canadian Institute of Chartered Accountants ("CICA") issued Handbook Section 3855, Financial Instruments – Recognition and Measurement ("Section 3855"), Handbook Section 1530, Comprehensive Income ("Section 1530"), Handbook Section 3251, Equity ("Section 3251"), and Handbook Section 3865, Hedges ("Section 3865"). The new standards are effective for the Company's interim and annual financial statement commencing January 1, 2007. Section 1530 establishes standard for reporting and presenting comprehensive income, which is defined as the change in equity from transactions and other events from non-owner sources. Other comprehensive income refers to items recognized in comprehensive income that are excluded from net income calculated in accordance with generally accepted accounting principles. Under the new standards, policies followed for periods prior to the effective date generally are not reversed and therefore, the comparative figures have not been restated. The adoption of these new standards had no impact on opening deficit as of January 1, 2007.

Under Section 3855, financial instruments must be classified in one of these five categories: i) held-for-trading; ii) loans and receivables; iii) held-to-maturity; iv) available for sale; or v) other financial liabilities. All financial instruments, including derivatives, are measured in the balance sheet at fair value except for loans and receivables, held-to maturity investments and other financial liabilities which are measured at amortized cost. Subsequent measurement and changes in fair value will depend on their initial classification, as follows: held-for-trading financial assets are measured at fair value and changes in fair value are recognized in net income; and available-for-sale financial instruments are measured at fair value with changes in fair value recorded in other comprehensive income until the investment is derecognized or impaired at which time the amounts would be recorded in net income.

Upon adoption of the new standards, the Company has designated its cash and cash equivalents as held-for-trading which are measured at fair value with changes recorded in the consolidated statement of earnings and deficit as interest income. Accounts receivable are classified as loans and receivables, which are measured at amortized cost and consistent to the Company's accounting policy prior to the adoption of section 3855. Accounts payable and accrued liabilities have been classified as other financial liabilities, which are accounted for at amortized cost using the effective interest method. Given the current nature of the Company's accounts receivable and payable balances, the impact of discounting using the effective interest rate method would not result in significantly different amounts than carrying value. The Company had no held-to-maturity or available for sale financial assets during the year ended December 31, 2007.

Transaction costs that are directly attributable to the acquisition or issuance of financial assets or liabilities are accounted for as part of the respective asset or liability's carrying value at inception.

The Company reviewed significant contracts in effect on January 1, 2007 and during the year ended December 31, 2007 and determined that there are no significant embedded derivatives or non-financial derivatives that require separate fair value recognition on the consolidated balance sheet on the transition date of January 1, 2007 or at December 31, 2007.

Disclosure of comprehensive income/(loss) was added to the Company's consolidated financial statements. The Company had no other comprehensive income/ (loss) transactions during the year ended December 31, 2007. For all periods presented, there is no difference between the Company's comprehensive income/(loss) and loss for the year. The adoption of these standards had no impact on the Company's loss for the year ended December 31, 2007. Accumulated other comprehensive income forms part of shareholders' equity.

In December 2006, the CICA issued Handbook Section 3862, Financial Instruments - Disclosures, and Handbook Section 3863, Financial Instruments – Presentation. These new standards will become effective for the Company

beginning January 1, 2008. The Company is currently assessing the impact of these two new standards on its consolidated financial statements.

(c) Recently Issued Pronouncements:

In December 2006, the CICA issued Handbook Section 1535, Capital Disclosures, which provides standards for disclosures regarding a company's capital and how it is managed. Enhanced disclosure with respect to the objectives, policies and processes for managing capital and quantitative disclosures about what a company regards as capital is required. These recommendations are effective for fiscal years beginning on or after October 1, 2007 and, therefore, the Company will be required to implement these standards on January 1, 2008. The Company is evaluating the impact of this standard on its consolidated financial statements.

(d) Goodwill and customer assets:

Goodwill is the residual amount that results when the purchase price of an acquired business exceeds the sum of the amounts allocated to the identifiable tangible and intangible assets acquired, less liabilities assumed, based on their fair values. When the Company enters into a business combination, the purchase method of accounting is used. Goodwill is assigned as of the date of the business combination to reporting units that are expected to benefit from the business combination. Goodwill is not amortized but instead is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test is carried out in two steps. In the first step, the carrying amount of the reporting unit, including goodwill, is compared with its fair value. When the fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered to be impaired and the second step of the impairment test is unnecessary. The second step is carried out when the carrying amount of reporting unit exceeds its fair value, in which case, the implied fair value of the reporting unit's goodwill, determined in the same manner as the value of goodwill is determined in a business combination, is compared with its carrying amount to measure the amount of the impairment loss, if any.

During the third quarter of 2005, a customer contract related to the Company's Caradas reporting unit expired and accordingly a goodwill and customer asset impairment analysis was performed for the Caradas reporting unit. The impairment analysis indicated that the fair values of goodwill and customer assets were nil, and the Company recorded a goodwill write down of \$1,894,690 and a customer assets write down of \$330,768. The impairment analysis for DSS Technologies (DSS) indicated that the fair value of goodwill was nil and accordingly recorded an impairment charge of \$392,242, which is included in discontinued operations (note 2). Application of the goodwill impairment test requires judgment, including assignment of assets and liabilities and determination of the fair value of each reporting unit. The fair value of each reporting unit is estimated using a discounted cash flow methodology. This requires significant judgments including estimation of future cash flows, which is dependent on internal forecasts, estimation of the long-term rate of growth for our business, the useful life over which cash flows will occur, and determination of discount rate and terminal asset value.

The changes in the carrying amount of goodwill for the years ended December 31, 2007, 2006 and 2005 are as follows:

Balance December 31, 2004	2,286,932
Goodwill impairment charges during 2005	(2,286,932)
<u>Balance December 31, 2005, 2006 and 2007</u>	<u>\$ —</u>

(e) Impairment or disposal of long-lived assets:

The Company reviews capital and intangible assets (long-lived assets) for impairment on an annual basis or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Absent any triggering factors during the year, the Company conducts its long-lived asset assessment in the fourth quarter to correspond with its planning cycle. An impairment loss is recognized when the carrying amount of an asset that is held and used exceeds the projected undiscounted future cash flows expected from its use and disposal, and is measured as the amount by which the carrying amount of the asset exceeds its fair value which is measured by discounted cash flows when quoted market prices are not available. For assets available-for-sale, an impairment loss is recognized when the carrying amount exceeds the fair value less costs to sell.

(f) Revenue recognition:

The Company recognizes revenue in accordance with Statement of Position ("SOP") 97-2, Software Revenue Recognition, issued by the American Institute of Certified Public Accountants ("AICPA") in October 1997 as amended by SOP 98-9 issued in December 1998. The Company derives revenue from licensing its products and providing related services, including installation, integration, and maintenance.

(i) License revenue:

The Company recognizes product revenue when it has an executed license agreement with the customer, the software product has been delivered, the amount of the fees to be paid by the customer is fixed and determinable, and collection of these fees is deemed probable. The Company considers fees related to arrangements with significant payments due

beyond its normal trading terms not to be fixed or determinable. If the fee is not fixed or determinable, revenue is recognized as the payments become due from the customer. If collectibility is not considered probable, revenue is recognized when the fee is collected.

The Company enters into software license agreements that provide for future license payments to be made based on the number of users. Customers who exceed their licensed fixed level of users are required to pay additional license fees. Revenue associated with additional users is recognized when the amount becomes determinable, and when the requirements of revenue recognition as set out above have been met.

(ii) Service revenue:

Typically, software license agreements are multiple element arrangements as they also include consulting, related maintenance and/or implementation services fees. Arrangements that include consulting services are evaluated to determine whether those services are essential to the functionality of other elements of the arrangements. The Company's software products are generally fully functional upon delivery and implementation and do not require any significant modification or alteration for customer use, however, for larger customers, customization services may be significant. Customers generally purchase consulting services to facilitate the adoption of the Company's technology and may contract with the Company to have dedicated personnel to participate in the services being performed, but the customer may also decide to use their own resources or appoint other professional service organizations to provide these services.

In determining whether the services are essential to the functionality of its software, the Company applies the criteria in SOP 97-2. When the services are considered essential to the functionality of the software, the Company recognizes both the software product revenue and services revenue under the percentage of completion method using the input method based on the ratio of direct labour hours incurred to date to total projected labour hours. When services are not considered essential, the entire arrangement fee is allocated to each element in the arrangement based on the respective vendor specific objective evidence ("VSOE") of the fair value of each element. VSOE used in determining the fair value of license revenue is based on the price charged by the Company when the same element is sold in similar quantities to a customer of similar size and nature. VSOE used in determining fair value for installation, integration and training is based on the standard daily rates for the type of service being provided multiplied by the estimated time to complete the task. VSOE used in determining the fair value of maintenance and technical support is based on annual renewal rates. The revenue allocable to the software license is recognized when the product revenue criteria are met. The revenue allocable to the consulting services is recognized as the services are performed. In instances where VSOE exists for undelivered elements but does not exist for delivered elements of a software arrangement, the Company uses the residual method of allocation of the arrangement fees for revenue recognition purposes. For arrangements containing multiple elements wherein VSOE of fair value does not exist for all undelivered elements, revenue for the delivered and undelivered elements is deferred until VSOE of fair value exists or all elements have been delivered.

Consulting, implementation and training revenues are recognized as the services are performed, generally on a time and materials basis. Consulting revenues attributed to fixed price arrangements are recognized using the proportional performance method based on direct labour costs incurred to date as a percentage of total estimated direct labour costs to complete the project as this better reflects the pattern in which the Company's obligations to its customers are fulfilled and revenue is earned. When total cost estimates exceed revenues in a fixed price arrangement, the estimated losses are recognized immediately based upon an average fully burdened daily cost rate applicable to the consulting individuals delivering the services.

(iii) Maintenance revenue:

Maintenance and support revenues paid in advance are non-refundable and are recognized ratably over the term of the agreement, which typically is twelve months.

The Company provides upgrade rights only as part of Post-contract Customer Support ("PCS" or "maintenance") arrangements. Maintenance generally includes the right to receive unspecified updates and upgrades, determined solely by the Company, after the software license period begins. These unspecified update and upgrade rights generally provide for the customer to receive bug fixes and future enhancements, respectively, to the existing software. The Company does not enter into arrangements that provide for "specified" upgrade rights. "Unspecified" updates and upgrades are included in maintenance revenue. Maintenance revenue is recognized ratably over the term of the maintenance contract.

(iv) Deferred revenue:

Product and services revenues that have been prepaid but do not yet qualify for recognition as revenue under the Company's revenue recognition policy are reflected as deferred revenue on the consolidated balance sheets.

(g) Cash and cash equivalents:

Cash and cash equivalents include cash on account and short-term investments in money market instruments with original maturities of 90 days or less when acquired.

(h) Investment tax credits:

Investment tax credits are accrued when qualifying expenditures are made and there is reasonable assurance that the credits will be realized. Investment tax credits earned with respect to current expenditures for qualified research and development activities are included in the consolidated statements of earnings and deficit as a reduction of related expenses in the year the refund is received. In 2007, the Company reduced research and development expenses by \$87,000 (2006 - \$288,000, 2005 - \$nil) for refunds received during the year in relation to the prior year's scientific research and development claims. Assistance related to the acquisition of capital assets used for research and development is credited against the related capital assets.

(i) Research and development costs:

Research costs are expensed as incurred. Software development costs are deferred once costs meet the criteria under Canadian generally accepted accounting principles for deferral and amortization. Such deferred costs are amortized, commencing when the product is commercially released, on a straight-line basis over two years. The recoverability of any unamortized deferred development costs is reviewed on an ongoing basis.

(j) Purchased and acquired technology:

The Company capitalizes purchased technology and amortizes such costs over its estimated useful life. The carrying value is assessed on a periodic basis to determine if a write-down is required.

(k) Customer assets:

Customer relationships acquired through business combinations are amortized over their estimated useful life. Acquired customer contract assets are amortized over the related contract terms as services are performed. The carrying value is assessed on a periodic basis to determine if a write-down is required.

(l) Foreign currency translation:

The Company uses the U.S. dollar as its measurement and reporting currency in the preparation of its consolidated financial statements.

Monetary assets and liabilities denominated in foreign currencies are translated into United States dollars at the exchange rates prevailing at the consolidated balance sheet dates. Non-monetary assets and liabilities are translated at historical rates. Transactions in foreign currencies are translated into United States dollars at the approximate rates prevailing at the dates of the transactions. Foreign exchange gains and losses are included in the loss for the period.

(m) Capital assets:

Capital assets are stated at cost less accumulated depreciation and amortization. Depreciation and amortization is provided over the estimated useful lives of the assets at the following annual rates and bases:

Asset	Basis	Rate
Computer hardware	Declining balance	30%
Computer software	Declining balance	30%
Furniture and fixtures	Declining balance	20%
Leasehold improvements	Straight-line	Over term of lease

(n) Income taxes:

The Company accounts for income taxes using the asset and liability method. Under this method, future income taxes are recognized at the enacted or substantively enacted tax rate expected to be applicable at the date of reversal for all significant temporary differences between the tax and accounting bases of assets and liabilities and for certain tax carry forward items. Future income tax assets are recognized only to the extent that, in the opinion of management, it is more likely than not that the future income tax assets will be realized. Future income tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of the substantive enactment of the change.

(o) Earnings per share:

Basic earnings per share is computed using the weighted average number of common shares that are outstanding during the year. Diluted earnings per share is computed using the weighted average number of common and potential common shares outstanding during the year. Potential common shares consist of the incremental number of common shares issuable upon the exercise of stock options and warrants and are calculated using the treasury stock method.

(p) Stock-based compensation:

The Company estimates the fair value of stock-based compensation granted to employees since November 1, 2002 and expenses the fair value over the estimated vesting period of the stock options.

(q) Measurement uncertainty:

The preparation of these consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of these consolidated financial statements and the reported amounts of revenue and expenses during the year. Significant estimates are used in determining, but not limited to, the

allowance for doubtful accounts income tax valuation allowance, stock based compensation, the useful lives of depreciable assets and the recoverability of fixed assets. Actual results could differ from those estimates.

**2. Acquisitions and discontinued operations:**

In February 2005, the Company's subsidiary DSS Software Technologies (DSS) completed an agreement whereby it sold the majority of its current assets, capital assets, current liabilities, consultant and customer accounts for \$250,000. Diversinet is entitled to a five-year annual fee of up to \$120,000 per year based on the purchaser meeting certain gross profit and net profit criteria. These amounts will be recorded as income from discontinued operations, if and when received.

The results of DSS have been excluded from continuing operations in the statements of operations and deficit for all periods presented. The following summarises the impact of discontinued operations on the balance sheet and statement of operations and deficit for all periods presented.

For the year ended December 31:	2007	2006	2005
Income Statement	\$	\$	\$
Revenue	–	–	453,361
Expenses	–	–	820,772
Income (loss) from discontinued operations	–	–	(367,411)
Gain on disposition of discontinued operations	–	–	296,551
Loss from discontinued operations	–	–	(70,860)
Loss per share from discontinued operations	–	–	0.00

Expenses in the loss on disposition of discontinued operations includes the elimination of the related goodwill of \$nil (2006 - \$nil, 2005 - \$392,242).

**3. Accounts receivables and allowance for doubtful accounts:**

	2007	2006
Accounts receivable:		
Amount billed	\$ 122,687	\$ 174,109
Unbilled	–	–
Allowance for doubtful accounts	–	(20,000)
	\$ 122,687	\$ 154,109

Unbilled receivables represent the recognized sales value of customer contracts that had not been billed and were not billable to the customers at the balance sheet date. The balances will be billed upon the fulfillment of certain conditions agreed between the parties. The Company recognizes an allowance for doubtful accounts. The allowance is assessed based on a variety of factors, including the length of time receivables are past due, circumstances relating to the customer, and historical experience.

**4. Capital assets:**

December 31, 2007	Cost	Accumulated depreciation and amortization	Net book value
Computer hardware	\$ 1,276,022	\$ 1,089,351	\$ 186,671
Computer software	535,107	470,611	64,496
Furniture and fixtures	321,301	220,992	100,309
Leasehold improvements	36,060	7,543	28,517
	\$ 2,168,490	\$ 1,788,497	\$ 379,993
December 31, 2006	Cost	Accumulated depreciation and amortization	Net book value
Computer hardware	\$ 1,236,368	\$ 1,017,847	\$ 218,521
Computer software	513,518	447,595	65,923
Furniture and fixtures	280,867	200,971	79,896
Leasehold improvements	26,821	2,438	24,383
	\$ 2,057,574	\$ 1,668,851	\$ 388,723

Depreciation expense for the year ended December 31, 2007 amounted to \$119,647 (2006 - \$159,048).

**5. Accrued liabilities:**

	2007	2006
--	------	------

Compensation	\$ 522,029	\$ 252,928
Professional fees	131,658	121,194
Litigation provision	–	214,537
Miscellaneous	77,774	45,002
	\$ 731,461	\$ 633,661

## 6. Share capital, warrants and common share purchase options:

There are an unlimited number of authorized common shares with no par value.

The following details the changes in issued and outstanding shares, compensation options and warrants:

	Compensation options and warrants		Common shares	
	Number	Amount	Number	Amount
Balance December 31, 2004	2,568,404	\$ 2,830,929	19,157,941	\$ 52,445,135
Private Placement (c)	71,250	25,066	5,000,000	1,800,117
Acquisition of Caradas (b)	(100,000)	(335,300)	–	–
Professional services (d)	375,000	72,353	–	–
Warrants cancelled and expired (e)	(701,404)	(92,071)	–	–
Board compensation (i)	–	–	130,000	85,400
Stock options exercised (a)	–	–	28,750	17,000
Balance December 31, 2005	2,213,250	\$ 2,500,977	24,316,691	\$ 54,347,652
Private Placement (f)	6,680,001	1,139,741	6,680,001	2,848,259
Private Placement (g)	1,634,617	266,616	1,634,617	722,670
Professional services (h)	113,179	25,254	95,179	61,457
Board compensation (i)	–	–	300,000	186,000
Warrants cancelled and expired (e)	(597,000)	(640,756)	–	–
Employee bonus (j)	–	–	159,642	84,543
Stock options and warrants exercised (a)	–	–	226,875	163,455
Balance December 31, 2006	10,044,047	\$ 3,291,832	33,413,005	\$ 58,414,036
Private Placement (k)	–	–	6,756,757	4,965,253
Professional services (l)	80,000	16,432	511,250	368,358
Board compensation (i)	–	–	375,000	280,750
Warrants cancelled and expired (e)	(1,588,179)	(1,455,207)	–	–
Employee bonus (j)	–	–	846,708	516,409
Stock options and warrants exercised (a) (b)	(650,000)	(307,140)	1,265,063	825,901
Balance December 31, 2007	8,585,868	\$ 1,555,453	43,167,783	\$ 65,370,707

Shares issued for other than cash consideration are valued at their market price at the date of agreement for issuance.

- During 2005, 2006, and 2007 the Company granted options to certain employees, officers and directors under a share option plan (note 11), enabling them to purchase common shares of the Company.
- On September 1, 2003, Diversinet acquired 100% of the outstanding shares of Caradas, Inc. The aggregate consideration was 1,417,500 Diversinet common shares and 200,000 share purchase warrants. The share purchase warrants are exercisable at \$2.45 per share for five years. During 2004, 100,000 share purchase warrants were cancelled and the remaining warrants were repriced to \$0.40. During 2005, the remaining 100,000 share purchase warrants were cancelled and the value transferred to contributed surplus.
- On September 26, 2005, the Company completed a private placement of 5,000,000 common shares and 71,250 common share purchase warrants for gross proceeds of \$2,000,000. Each warrant entitles the holder thereof to acquire one common share at a price of \$0.40 per common share for a period of up to three years starting September 26, 2005.
- Professional services:

The following chart summarizes the activity during the year ended December 31, 2005:

	Compensation options and warrants	
	Number	Amount
Advisory board consulting services (i)	125,000	\$ 32,119
Consulting services (ii)	30,000	7,023
Consulting services (iii)	15,000	3,959

Consulting services (iv)	30,000	17,946
Consulting services (v)	50,000	2,528
Consulting services (vi)	25,000	4,061
Consulting services (vii)	100,000	4,717
	375,000	\$ 72,353

- (i) On April 1, 2005, the Company issued common share purchase warrants to each of the members of our advisory board. These warrants vest at a rate of 8.3% per month over a one-year period and expire on December 31, 2006. Each holder of these warrants is entitled to purchase common shares at \$0.66 per share. During 2006, 25,000 warrants were exercised and the remainder expired unexercised.
- (ii) On March 15, 2005, the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that was exercisable from November 20, 2005 to March 20, 2006 to purchase up to 30,000 of our common shares at \$0.80 per share. These warrants expired unexercised.
- (iii) On July 21, 2005, the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that was exercisable from April 20, 2006 to July 20, 2006 to purchase up to 15,000 of our common shares at \$0.62 per share. These warrants expired unexercised.
- (iv) On July 21, 2005, the Company entered into a consulting agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that is exercisable from February 28, 2008 to May 31, 2008 to purchase up to 30,000 of our common shares at \$0.71 per share.
- (v) On September 8, 2005, the Company entered into an agreement for consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that is exercisable from September 7, 2006 to September 7, 2008 to purchase up to 50,000 of our common shares at \$0.40 per share.
- (vi) On September 15, 2005, the Company entered into an agreement for professional services of a technical consultant. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that was exercisable from May 15, 2006 to September 15, 2006 to purchase up to 25,000 of our common shares at \$0.40 per share. These warrants expired unexercised.
- (vii) On July 30, 2005 the Company entered into an agreement for professional services. In consideration for the services to be rendered in accordance with the agreement, a warrant was issued that was exercisable from July 30, 2005 to July 30, 2006 to purchase up to 100,000 of our common shares at \$0.63 per share. These warrants expired unexercised.
- (e) Amount related to warrants expiring during the period unexercised. The value of warrants that have vested prior to the cancellation or expiration date has been reclassified to contributed surplus.
- (f) On June 30, 2006, the Company completed a private placement of 6,680,001 units, at \$0.60 per unit, for gross proceeds of \$4,008,000. Each unit is comprised of one common share, one-half common share purchase warrant at \$0.75 and one-half common share purchase warrant at \$0.90. Each whole warrant will be exercisable to purchase one common share and will expire on June 30, 2008. The Company allocated \$1,139,741 of the net proceeds to the warrants and \$2,868,000 less costs of 19,741 to share capital based on their estimated relative fair value.
- (g) On July 26, 2006, the Company completed a private placement of 1,538,463 units, at \$0.65 per unit, for gross proceeds of \$1,000,000 and issued 96,154 units for consulting services related to the private placement. Each unit is comprised of one common share and one common share purchase warrant. The warrant will be exercisable to purchase one common share for each whole warrant at a price of \$1.00 and will expire on July 26, 2008. The Company allocated \$266,616 of the net proceeds to the warrants and \$754,000, less costs of \$31,330, to share capital based on their estimated relative fair value.
- (h) Professional services:

The following chart summarizes the activity during the year ended December 31, 2006:

	Compensation options and warrants		Common shares	
	Number	Amount	Number	Amount
Consulting services (i)	95,179	\$ 20,873	95,179	\$ 61,457
Consulting services (ii)	18,000	4,381	—	—
	113,179	\$ 25,254	95,179	\$ 61,457

- (i) On January 1, 2006, the Company entered into an agreement for public relations services. In consideration for the services to be rendered in accordance with the agreement, a combination of common shares and common share purchase warrants were issued each quarter. Of the common share purchase warrants issued, 30,000 are exercisable at \$1.00 and vested on March 30, 2006, 25,000 are exercisable at \$1.20 and vested on June

30, 2006, 21,429 are exercisable at \$1.40 and vested on September 30, 2006 and the remaining 18,750 are exercisable at \$1.60 and vested on December 31, 2006. These common share purchase warrants expired on December 31, 2007.

- (ii) On September 6, 2006, the Company entered into an agreement for marketing consulting services. In consideration for the services to be rendered in accordance with the agreement, a warrant to purchase 25,000 common shares at \$0.56 was issued with equal vesting on each of October 6, November 6 and December 6, 2006. During 2006, 7,000 warrants were exercised. These warrants expired on September 6, 2007.
- (i) On May 12, 2005, July 31, 2006, August 2, 2007 and October 3, 2007 the Company issued common shares to each non-management board member in lieu of cash compensation.
- (j) During 2006 and 2007 common shares were issued to employees in lieu of cash bonuses.
- (k) On August 31, 2007, the Company completed a private placement with Hospital Service Association of Northeastern Pennsylvania ("HSA") of 6,756,757 common shares at \$0.74 per common share, for gross proceeds of \$5,000,000. Cost of the transaction totaled approximately \$35,000 and was netted against share capital as they were direct and incremental to the share offering. Subsequent to the issuance of the shares, the Company filed the appropriate documents to register the shares with the SEC. The related share agreement provides HSA with a number of put rights that would require the Company to repurchase all or a portion of its shares. These rights include (i) change of control put right whereby HSA has the right, at its option, to require the Company to repurchase the shares at a price of \$0.74 per share, if upon a change of control event, the consideration offered is less than \$0.74 per share; (ii) termination by the Company of the Revenue Share Agreement between the Company and AllOne Health Group Inc.; (iii) issuance of any class of shares of the Company with rights or preferences superior to the common shares issued to the purchaser; and (iv) breach by the Company of any material covenants contained in the share purchase agreement.
- (l) Professional services:

The following chart summarizes the activity during the year ended December 31, 2007:

	Compensation options and warrants		Common shares	
	Number	Amount	Number	Amount
Consulting services (i)	80,000	\$ 16,432	80,000	\$ 61,545
Consulting services (ii)	—	—	375,000	265,750
Consulting services (iii)	—	—	56,250	41,063
	80,000	\$ 16,432	511,250	\$ 368,358

- (i) On January 1, 2007, the Company entered into an agreement for public relations services. In consideration for the services to be rendered in accordance with the agreement, a combination of common shares and common share purchase warrants were issued each quarter. Of the common share purchase warrants issued, 15,000 are exercisable at \$1.50 and vested on March 30, 2007, 18,000 are exercisable at \$1.65 and vested on June 30, 2007, 22,000 are exercisable at \$1.80 and vested on September 30, 2007 and the remaining 25,000 are exercisable at \$2.00 and vested on December 31, 2007. These common share purchase warrants expire on December 31, 2008.
- (ii) On April 2, 2007, Albert Wahbe entered into an agreement to serve as Chief Executive Officer until at least June 30, 2008. Compensation under this agreement includes 25,000 common shares per month. Share compensation for 2007 was \$168,250 representing the issuance of 225,000 common shares. Under the same agreement, Mr. Wahbe is entitled a bonus of up to an additional 200,000 common shares of the Company annually, based on meeting targets established by the Board of Directors. In December 2007 Mr. Wahbe received a bonus of 150,000 common shares valued at \$97,500.
- (iii) On April 15, 2007, James Wigdale entered into a consulting agreement to provide services in a sales capacity. Compensation under this agreement is \$15,000 per month as well as participating in sales commissions based on revenues. In the first three months of his consulting agreement, in lieu of cash, Mr. Wigdale accepted 56,250 common shares.

## 7. Basic and diluted loss per share:

Common shares issuable upon the exercise of options and warrants that could dilute basic loss per share in the future were not included in the computation of diluted loss per share because to do so would have been anti-dilutive for all periods presented. Anti-dilutive options amounted to 3,352,850 at December 31, 2007, 2,174,349 at December 31, 2006, and 2,409,873 at December 31, 2005. Anti-dilutive warrants amounted to 8,585,868 at December 31, 2007, 10,044,047 at December 31, 2006, and 2,213,250 at December 31, 2005 respectively.

## 8. Income taxes:

The tax effects of significant temporary differences representing future tax assets is as follows:

	2007	2006

Future tax assets:		
Operating loss carryforwards	\$6,883,838	\$10,429,483
Capital loss carryforwards	656,505	747,058
Share issue costs	120,446	118,643
Research and development costs	3,546,844	3,382,463
Capital assets, accounting basis less than tax basis	6,008,434	5,886,872
	17,216,067	20,564,518
Valuation allowance	(17,216,067)	(20,564,518)
Net future tax assets	\$ –	\$ –

In assessing the realizability of future tax assets, management considers whether it is more likely than not that some portion or all of the future tax assets will not be realized. The ultimate realization of future tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers projected future taxable income, uncertainties related to the industry in which the Company operates and tax planning strategies in making this assessment.

At December 31, 2007, the Company has non-capital losses available for carryforward for Canadian income tax purposes amounting to \$19,562,000. These losses expire in the following fiscal years:

2008	4,182,000
2009	475,000
2010	5,084,000
2014	3,128,000
2015	3,997,000
2026	1,901,000
2027	795,000
	<u>\$ 19,562,000</u>

The Company also has non-capital losses available for carryforward for United States income tax purposes amounting to \$3,104,000, expiring between 2018 and 2027.

## 9. Segmented information:

The Company operates in a single reportable operating segment. This segment derives its revenue from the sale of secured wireless and identity management solutions and related products and services. As at December 31, 2007, 100% (2006 - 100%, 2005 - 100%) of the capital assets were located in Canada.

A summary of sales to major customers that exceeded 10% of total sales and the approximate amount due from these customers during each of the years in the three-year period ended December 31, 2007 are as follows:

	Sales			Accounts Receivable	
	2007	2006	2005	2007	2006
Customer 1	0%	56%	0%	–	–
Customer 2	19%	11%	0%	108,000	\$50,000
Customer 3	0%	11%	18%	–	–
Customer 4	0%	0%	29%	–	–
Customer 5	0%	0%	38%	–	–
Customer 6	46%	0%	0%	–	–
Customer 7	22%	0%	0%	–	–

Revenue is attributable to geographic location based on the location of the customer during each of the years in the three-year period ended December 31, 2007 are as follows:

	2007	2006	2005
Sales:			
United States	\$ 4,157,869	\$ 1,396,543	\$ 801,700
Canada	65,412	33,872	99,680
Asia	129,702	203,550	199,724
Other	184,000	33,000	–
	<u>\$ 4,536,983</u>	<u>\$ 1,666,965</u>	<u>\$ 1,101,104</u>

During each of the years in the three-year period ended December 31, 2007 revenue is attributable to products as follows:

	2007	2006	2005
--	------	------	------

Sales:			
Consulting services	\$ 1,579,248	\$ 1,576,965	\$ 1,101,104
Licensing	2,957,735	90,000	–
	\$ 4,536,983	\$ 1,666,965	\$ 1,101,104

## 10. Commitments and contingencies:

### (a) Litigation:

- (i) During fiscal 2000, the Company and its wholly owned Barbados subsidiary, The Instant Publisher Ltd., were sued by a company that alleged that the Company breached a dealer agreement entered into in 1995 by the Company's former printing business and is seeking damages of \$1,533,950 and damages of \$25,000,000 for loss of reputation and loss of opportunity, pre-judgment and post-judgment interest, and costs. During 2007, the parties entered into a settlement and release whereby the Company agreed to pay the plaintiff \$625,000 as full and complete settlement in the matter, including a court order dismissing the case.
- (ii) In addition to the above, in the ordinary course of business, the Company and its subsidiaries have legal proceedings brought against them.

### (b) Lease commitments:

Total future minimum lease payments including operating costs are as follows:

2008	248,753
2009	238,880
2010	238,880
2011	238,880
2012	79,626
2013	–
	\$ 1,045,019

Rental expense was \$209,569 for the year ended December 31, 2007 (2006 - \$155,000, 2005 - \$158,000).

## 11. Share option plan:

The Company grants options to certain employees, officers, directors and consultants under a share option plan (the "Plan"), enabling them to purchase common shares of the Company. The exercise price of an option under the Plan may not be less than the current market price of common shares on the day immediately proceeding the day the share option was granted. The Plan provides that the number of common shares reserved for issuance under the Plan shall not exceed 4,557,187 common shares (being 5,615,661 options reserved for issuance less 1,058,474 exercised to date). During 2005, the Company reduced the stock option vesting period from three years to two years (which has correspondingly shortened the expense amortization period) and also started to compensate Directors with stock grants or cash and option grants. This has increased compensation expense. As at December 31, 2007, the number of common shares reserved for future issues of stock options amounts to 1,204,337.

Assumptions used when valuing the options and warrants at their date of grant using the Black-Scholes option pricing model include: risk-free interest rate of 4% (2006 – 4%, 2005 – 3%), weighted average expected life of five years, expected dividend yield of 0% and average volatility of 117% (2006 – 150%, 2005 – 150%).

The following table summarizes information about stock options outstanding at December 31, 2007:

Options outstanding				Options vested	
Range of exercise price	Number outstanding	Weighted average remaining contractual life – years	Weighted average exercise price	Number exercisable	Weighted average exercise price
\$0.40 – \$0.75	1,168,901	2.48	\$ 0.43	1,067,042	\$ 0.42
\$0.82 – \$0.85	1,566,449	4.43	0.83	300,501	0.84
\$0.90 – \$2.45	617,500	3.01	1.60	356,292	1.81
	3,352,850	3.49	\$ 0.83	1,723,835	\$ 0.78

Changes for the employee stock option plan during the year ended December 31, 2007 were as follows:

Year ended 2007		Year ended 2006	
Number of shares	Weighted average exercise price	Number of shares	Weighted average exercise price

Options outstanding, beginning of year	2,174,349	\$ 0.83	2,409,873	\$ 0.98
Options granted	2,001,952	0.84	740,661	0.43
Options exercised	(615,063)	0.43	(194,875)	0.40
Options cancelled	(208,388)	2.60	(781,310)	1.03
Options outstanding, end of year	3,352,850	0.83	2,174,349	0.83
Options exercisable, end of year	1,723,835	0.78	1,784,036	0.91
Weighted average fair value of options granted during the year		\$ 0.69		\$ 0.39

The following table summarizes information about warrants outstanding at December 31, 2007:

Warrants outstanding		
Range of exercise price	Number outstanding	Weighted average remaining contractual life – years
\$0.40	121,250	0.72
\$0.62 - \$0.75	3,394,998	0.50
\$0.90 - \$1.00	4,974,620	0.52
\$1.50 - \$2.00	95,000	1.05
	8,585,868	0.52

During the year ended December 31, 2007, the Company recorded stock-based compensation expense of \$1,543,000 (2006 - \$906,000; 2005 - \$986,000) related to common shares, stock options and warrants granted to employees, officers, directors and consultants.

## 12. Financial instruments and risk management:

The Company is exposed to the following risks related to financial assets and liabilities:

### (a) Currency risk:

The Company is subject to currency risk through its activities in Canada, United Kingdom, Europe and Asia. Unfavourable changes in the exchange rate may affect the operating results of the Company.

The Company does not actively use derivative instruments to reduce its exposure to foreign currency risk. However, dependent on the nature, amount and timing of foreign currency receipts and payments, the Company may enter into forward exchange contracts to mitigate the associated risks. The Company has not entered into such contracts at December 31, 2007 and 2006.

### (b) Fair values:

The fair values of the Company's financial instruments approximate their carrying amounts due to their short-term nature.

### (c) Credit risk:

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash equivalents, short-term investments and accounts receivable. Cash equivalents and short-term investments are maintained at high-quality financial institutions.

The Company generally does not require collateral for sales on credit. The Company closely monitors extensions of credit. Management assesses the need for allowances for potential credit losses by considering the credit risk of specific customers, historical trends and other information.

### Valuation accounts and reserves:

Allowance for Doubtful Accounts	2007	2006	2005
Opening balance	\$ 20,000	\$ –	\$ 218,500
Write offs	(20,000)	–	(218,500)
Additions	–	20,000	–
Closing balance	\$ –	\$ 20,000	\$ –

Additions to the allowance to doubtful accounts are charged to the income statement through the bad debt expense as part of the general and administrative expenses.

## 13. Related party transactions:

During the years ended December 31, 2007 and 2006, the Company engaged in transactions in the normal course of operations with related parties. These transactions are measured at the exchange amount, which is the amount of consideration established and agreed to by the parties.

During the second quarter of 2007 Albert Wahbe was appointed Chief Executive Officer pursuant to a one year consulting agreement renewable for a further one year period at the discretion of the Board of Directors. Mr. Wahbe's compensation will consist solely of the issuance of 300,000 common shares of Diversinet annually and up to an additional 200,000 common shares of Diversinet annually based on meeting targets to be established by Diversinet's Board of Directors. Mr. Wahbe is entitled to Cdn\$4,000 per month in personal expenses. During 2007 he received 375,000 common shares and Cdn\$36,000 relating to this agreement. As part of the June 2006 private placement, Mr. Wahbe acquired 4,600,000 units. As of December 31, 2007, Albert Wahbe owns 5,075,000 common shares, 4,600,000 common share purchase warrants and 50,000 options, representing approximately 20.3% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants and options.

During January 2007 and December 2007, James Wigdale, Jr., one of our Directors, exercised 350,000 warrants (at \$0.60 per share) and 300,000 warrants (at \$0.40 per share) respectively, into common shares. Furthermore, an additional 750,000 held by Mr. Wigdale (at \$2.00 and \$2.05 per share) expired unexercised. During the second quarter of 2007, Mr. Wigdale began performing services in a sales capacity. During 2007 the Company paid Mr. Wigdale \$52,500 and issued him 56,250 common shares relating to his consulting agreement. Additionally, 25,000 common shares and 50,000 options were issued to Mr. Wigdale as Director compensation in 2007. As part of the June 2006 private placement, Lakefront Partners, LLC, a company controlled by Mr. Wigdale, acquired 666,667 units. As well, during the September 2005 private placement, Lakefront Partners, LLC acquired 725,000 common shares. In 2004 we completed two financings in which Lakefront Partners, LLC and Mr. Wigdale participated. As at December 31, 2007, Lakefront Partners, LLC owns 3,909,462 common shares and 666,667 common share purchase warrants, and Mr. Wigdale owns 1,111,250 common shares and 50,000 options, together representing approximately 13.1% of the issued and outstanding common shares of the Company, assuming the exercise of such warrants and options.

As part of the August 2007 private placement, BCNEPA acquired 6,756,757 common shares. In October 2007, BCNEPA received 100,000 common shares in regards to compensation for William Reed's participation on the Diversinet Board of Directors. As at December 31, 2007, BCNEPA owns 6,756,757 common shares representing approximately 15.9% of the issued and outstanding common shares of the Company.

**14. Reconciliation of Canadian and United States generally accepted accounting principles ("GAAP"):**

The consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles. Material differences between Canadian and United States generally accepted accounting principles are described below.

	2007	2006	2005
<b>Share capital:</b>			
Canadian GAAP	\$65,370,707	\$58,414,036	\$54,347,652
Elimination of reduction of share capital (a)	30,089,054	30,089,054	30,089,054
Reclassification of shares as redeemable preferred stock (b)	(4,965,253)	—	—
<b>U.S. GAAP</b>	<b>\$90,494,508</b>	<b>\$88,503,090</b>	<b>\$84,436,706</b>
<b>Deficit and comprehensive loss:</b>			
Canadian GAAP	\$(63,178,675)	\$(59,745,704)	\$(56,294,987)
Elimination of reduction of share capital (a)	(30,089,054)	(30,089,054)	(30,089,054)
Compensation expense (c)	(991,696)	(991,696)	(991,696)
<b>U.S. GAAP</b>	<b>\$(93,242,626)</b>	<b>\$(89,809,655)</b>	<b>\$(86,358,938)</b>
<b>Consolidated statements of loss:</b>			
Loss under Canadian GAAP	\$(3,432,971)	\$(3,450,717)	\$(7,109,496)
Compensation expense (c)	—	—	439,250
<b>Loss under U.S. GAAP</b>	<b>\$(3,432,971)</b>	<b>\$(3,450,717)</b>	<b>\$(6,670,246)</b>
<b>Basic and diluted loss per share under U.S. GAAP</b>	<b>\$(0.09)</b>	<b>\$(0.12)</b>	<b>\$(0.32)</b>
<b>Comprehensive loss under U.S. GAAP</b>	<b>\$(3,432,971)</b>	<b>\$(3,450,717)</b>	<b>\$(6,670,246)</b>

(a) Share capital and deficit:

On March 1, 1999, the shareholders approved a resolution to reduce the stated capital of the Company by \$30,089,054 to eliminate the deficit as at October 31, 1999. Under Canadian GAAP, a reduction of the carrying amount of share capital of outstanding common shares is allowed with a corresponding offset to deficit. This reclassification, which the Company made in 2000 to eliminate the deficit that existed at October 31, 1999, did not meet the criteria specified by U.S. GAAP and results in an increase to share capital with a corresponding increase in deficit of \$30,089,054.

(b) Reclassification of shares:

The August 31, 2007 private placement of 6,756,757 common shares at \$0.74 per common share for gross proceeds of \$5,000,000 included a change of control put right whereby the holder has the right, at its option to require the Company to repurchase the shares at a price of \$0.74 per share, if upon a change of control event, the consideration offered is less than \$0.74 per share. SEC Regulation 210.5-02 requires the Company to classify the shares as redeemable preferred stock (or temporary equity) as the shares are redeemable at the option of the holder and the conditions for redemption are not solely within the control of the Company. As at December 31, 2007 the redemption value of the shares is equal to the fair value as the maximum price the company would have to pay to the holder to redeem the shares is \$0.74 per share.

(c) Compensation expense:

Effective January 1, 2006, the Company is required to apply the provisions of FASB Statement No. 123R ("SFAS 123R"), which requires all share based payments to be recognized in the financial statements based on their fair values using either a modified - prospective or modified - retrospective transition method. The company has adopted this standard using the modified - prospective method and, therefore recognizes share-based compensation for any new share-based awards and awards modified, repurchased or cancelled after the required effective date, January 1, 2006. Under SFAS 123R, the company is required to determine the grant date fair value of the stock-based awards granted to employees. The company is continuing to use the Black-Scholes option pricing model to value these options. The related grant date fair value is subsequently recognized as stock-based compensation expense over the requisite service period. As a result, stock-based compensation expense recognized under U.S. GAAP after December 31, 2005 equals the amount recognized under Canadian GAAP when the fair value method has been applied since 2003. Previously, the Company adjusted compensation cost for actual forfeitures at the time forfeitures occurred. SFAS 123R requires the company to estimate forfeitures as part of the initial measure of the grant date fair value of the award. The cumulative effect of the change in accounting policy for the adjustment related to the forfeitures for the prior periods is not material at January 1, 2006.

(d) Notes to consolidated financial statements:

In order to comply with U.S. GAAP, the following note to the consolidated financial statements would need to be added:

Recent accounting pronouncements:

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), which replaces Accounting Principles Board Opinion No. 20, "Accounting Changes", and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS 154 provides guidance on the accounting for and reporting of changes in accounting principles and error corrections. SFAS 154 requires retrospective application to prior period's financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. Certain disclosures are also required for restatements due to correction of an error. SFAS 154 is effective for accounting changes and corrections of errors, made in fiscal years beginning after December 15, 2005. The impact that the adoption of SFAS 154 will have on the Company's results of operations and financial condition will depend on the nature of future accounting changes and the nature of transitional guidance provided in future accounting pronouncements.

## Executive Officers

**Albert Wahbe, Chairman & Chief Executive Officer** has served as a Director and Chairman since July 2006 and CEO since April 2007. Mr. Wahbe was previously Executive Vice President and Group Head, Global Transaction Banking at Scotiabank, where he led the evolution of e-commerce and e-banking to provide Global Business solutions. Mr. Wahbe was also CEO of e-Scotia, where he developed Scotiabank's Internet banking, e-commerce, wireless, telephone banking and smart card technologies for consumers. Prior to Scotiabank, Mr. Wahbe held senior management positions in marketing and technology operations at I.B.M. Canada. Mr. Wahbe graduated from the Harvard University Graduate School of Business in 1998, completing the Advanced Management Program and International Senior Management Program.

### **David Hackett, Chief Financial Officer and Corporate Secretary**

David Hackett joined Diversinet in 2002 having been the Chief Financial Officer and Corporate Secretary of Aucxis Corp., a technology and service provider to electronic marketplaces, where he oversaw start-up operations, public financing and acquisitions. Prior to that Mr. Hackett was Chief Financial Officer, Director and Corporate Secretary of EveryWare Development Inc. Mr. Hackett was instrumental in raising numerous financing rounds and acquisitions, including the eventual sale of EveryWare to Pervasive Software Inc. Mr. Hackett began his professional career at as a Chartered Accountant at Ernst & Young and holds an MBA with distinction from the Richard Ivey School of Business at the University of Western Ontario.

## Board of Directors

**Albert Wahbe** has served as Diversinet's Chief Executive Officer since April 2007.

**Ravi Chiruvolu** has served as a director since July 2006. Mr. Chiruvolu runs Top Shelf Capital, a venture fund focused on increasing shareholder value for small cap public companies. Prior to this, Mr. Chiruvolu was a managing director at Charter Venture Capital, where he ran a \$150m early stage fund. He holds an MBA from Harvard Business School and a Bachelor of Science and a Master of Science in Engineering from MIT. Mr. Chiruvolu is a leader in the venture capital industry as well as PIPE investing, and has written numerous articles in the Venture Capital Journal and spoken at several conferences on the topics.

**Gregory Milavsky** has served as a Director since April 2007. Mr. Milavsky has over 20 years of corporate finance, investment banking and private equity experience in Toronto, London, New York and Tokyo. He was Associate Director of Corporate Finance with CIBC Limited, Investment Banker with James D. Wolfensohn Incorporated, Senior Vice President and Director with Rothschild Canada, Chief Executive of Rothschild Quantico Capital, Managing Director and Group Head of Scotiabank Private Equity Investments and is currently Senior Advisor of Canterbury Park Capital. He holds an MBA with distinction from the Harvard Graduate School of Business Administration and a bachelor of applied science degree in civil engineering from the University of Toronto.

**William Reed** has served as a Director since August 2007. Mr. Reed is executive vice president for Hospital Service Association of Northeastern Pennsylvania (HSA of NEPA) d/b/a Blue Cross of Northeastern Pennsylvania (BCNEPA), and President and Chief Executive Officer of AllOne Health Group (AHG), a wholly-owned subsidiary of HSA of NEPA. Prior to joining BCNEPA, Mr. Reed held numerous management positions in healthcare provider organizations including Gentiva Health Services, Quantum Health Resources, and Geisinger Health System. Mr. Reed received his Bachelor of Science in business administration from Drexel University and his Master of Science in computer science from Rutgers University.

**Philippe Tardif** has served as a Director since March 2007. Mr. Tardif is a partner at the law firm Borden Ladner Gervais LLP and specializes in securities law and capital markets transactions. He also advises on corporate governance matters and acts as advisor to special committees and boards of directors. A past member of the Securities Advisory Committee to the Ontario Securities Commission and a member of the Securities Law Subcommittee of the Ontario Bar Association, Mr. Tardif was called to the Ontario Bar in 1987.

**James ('Jay') Wigdale** has served as a Director since January, 2005. Mr. Wigdale founded Lakefront Partners, LLC, a money-management firm, in 1998 and is the firm's Chief Investment Officer. Prior to founding Lakefront, he was senior VP of Institutional Sales and Regional Manager for Robert W. Baird & Co. Mr. Wigdale was also the VP of Corporate Banking from 1984 to 1990 at Barnett Bank, Inc. (now Bank of America). He holds a Bachelor of Science (Marketing) degree from Miami University of Ohio.

---

**Diversinet Corp.**

2235 Sheppard Avenue East  
Suite 1700  
Toronto, Ontario  
Canada M2J 5B5  
Tel: (416) 756-2324  
Fax: (416) 756-7346  
www.diversinet.com

**Transfer Agent:**

Computershare Investor  
Services Inc.  
100 University Avenue  
Toronto, Ontario  
Canada M5J 2Y1  
Tel: 1-800-564-6253  
www.computershare.com

**Auditors:**

KPMG, LLP  
Chartered Accountants  
Yonge Corporate Centre  
4100 Yonge Street Suite 200  
Toronto, Ontario  
Canada M2P 2H3  
Tel: (416) 228-7000

**Traded on:**

OTC Bulletin Board

**Symbol:**

DVNTF